INDONESIAN BOND MARKET: REDEMPTION IN AUGUST - DECEMBER 2005

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A b s t r a k s i

Pasar Obligasi dan reksadana relatif masih baru di pasar keuangan Indonesia. Namun demikian, perkembangan kedua pasar tersebut cukup menjanjikan baik dari sisi jenis instrumen yang ditawarkan, jumlah investor maupun nilai investasi yang ditanamkan. Pada periode Agustus - Desember 2005 lalu, kedua pasar tersebut mendapat tekanan yang cukup berat dan hampir menumbangkan perusahan-perusahaan sekuritas besar karena besarnya jumlah likuiditas yang ditarik investor (redemption).

Paper ini mencoba menganalisa kejadian yang menimpa pasar obligasi dan reksadana tersebut baik sumber tekanan yang utamanya adalah berasal dari faktor makroekonomi dan faktor pasar, besarnya dampak redemption *sampai ke langkah-langkah penyelematan yang ditempuh pemerintah (Bank Indonesia, Bapepam, dll).*

Ke depannya, para pelaku pasar termasuk para investor harus lebih mendapat edukasi yang benar dan positif mengenai investasi di pasar obligasi maupun reksadana. Selain itu, regulator juga diharapkan dapat mematangkan perkembangan kedua pasar melalui peraturan-peraturan yang mendukung termasuk proses komunikasi peraturan-peraturan tersebut kepada seluruh pihak terkait di pasar obligasi maupun reksadana.

Keywords: ITF, BI Rate, hedged bond, guaranteed deposit, NAV, core inflation

JEL Classification: E44, G11

1 Rifki Ismal is Assistant to Deputy Governor of Bank Indonesia. Opinions expressed are those of the author and not necessarily represent those of Bank Indonesia. The author wishes to express his deep gratitude to Dr. Guonan Ma, Dr. Eli Remolona, Dr. Robert N Mc Cauley for their comments and contributions as well as to all staff of BIS Rep office for Asia and Pacific.

I. Overview

Indonesian economy showed optimism in the period of 2003 up to mid 2005. Inflation was under controlled, Rupiah exchange rate was stable and GDP has been growing progressively since 2003. In particular, inflation quarter to quarter (q-t-q) in 2005 was around 1% - 3% (q-t-q) due to increased trend in economic growth followed by good coordination in fiscal and monetary policy. Rupiah moved relatively stable from January 2005-July 2005 in range Rp9200/USD-Rp9800/USD owing to conducive fundamental economics, positive public expectation with regard to new government[2] and equilibrium supply and demand of foreign exchange in the market. As of this, SBI rate (central bank's interest rate) lied in low level (between 7%-8%) during 2003-2005 to strongly support economic activities while kept aware of tolerable inflation rate. Therefore, GDP-one of the most important economic indicators- confirmed positive performance. It was 6.12% (y-o-y) in 1st quarter of 2005 and a little bit decelerating to 5.34% (y-o-y) in 3rd quarter but with an increase share of investment to equalize high consumption.

Nevertheless, in August–September 2005 (3rd quarter of 2005) there were some external factors influenced the economy. The biggest ones were coming from world oil price soaring up to USD70/ barrel and tight monetary policy from developed countries mainly in US. World oil price directly influenced the performance of previous economic indicators including balance of payment and financial market as well. In balance of payment, whereas oil import was the major part of import activities fueled by high domestic oil consumption, the world oil price hike became a serious problem.

Finally, this condition ended up with a pressure on Rupiah exchange rate which going up to Rp10,000-Rp11,000/USD in August–September 2005 followed by mounting in inflation because the government lessened oil subsidy in Government Budget (APBN) by adjusting domestic fuel price. As a response, Bank Indonesia moved BI-Rate[3] up to lowering the inflation pressures, assuring mid term inflation target to be achieved and maintaining the stable macroeconomic condition.

On the whole, Rupiah depreciation, towering inflation and monetary policy respond to increase BI-rate have totally affected both domestic bond market and mutual fund market

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2 President Susilo Bambang Yudhoyono became President of Indonesia in October 2005.

3 In July 2005, Bank Indonesia launched a new monetary policy framework known as the Inflation Targeting Framework, which has four basic elements as follows:
(1) use of the BI rate as a reference rate in monetary control in replacement of the base money operational target,
(2) forward looking monetary policymaking process,
(3) more transparent communications strategy, and
(4) strengthening of policy coordination with the Government.

whereas bond took dominant part in their investment portfolio. Panic selling happened in that time followed by falling down of bond prices and trading value went up due to that panic. Instead of shock in economic indicators, the bearish condition was also triggered by mark to market policy from Indonesian Capital Market Agency (Bapepam). Lately, this redemption case has given very good lessons to all parties involved in Indonesian financial market.

II. Economic and Financial Market Performance before Redemption

II.1 Promising Macroeconomics Indicators

Along 2005, inflation was relatively under controlled except the one when oil price hike damped the economy and pressed on the government to improve domestic fuel price. From 2003 up to August 2005, inflation rate year on year (y-o-y) series was around 8% and month to month (m-t-m) inflation rate series was slightly 1% and even never reached 2% (Figure III.1). Just in 2005, it was recorded 3.19% (q-t-q) in 1st quarter, and decelerated to 1.05% (q-t-q) in 2nd quarter and 2.03% (q-t-q) in 3rd quarter. At least, these figures reflected a good coordination between monetary policy from the central bank and fiscal policy from the government. Likewise, as the inflation rate is foremost exaggerated by core and non-core inflation (noise inflation), this also applies in Indonesia. During that period, since there were tiny effects from noise inflation (less significant policies on the administered prices and low pressures from volatile food) combined with macroeconomic stability caused partially by well-determined monetary policy to guard inflation (core inflation), the overall pressure on inflation was recorded very low.

From the external side, Rupiah exchange rate was relatively stable in range Rp9200/USD-Rp9800/USD owing to conducive fundamental economics, positive public expectation with regard to democratic general election up to the announcement of new cabinet as well as equal supply and demand of foreign exchange in the market. As a result, non oil export and non oil import activities persistently grew annually to 13.8% (export) and 25% (import) with the last value recorded USD6.23 billion (export) and USD4.48 billion (import) (Figure III.2). The same figure occurred in investment side, investment took place in boosting the economy with USD2.2 billion (FDI in 2nd quarter 2005) and USD2.3 billion (Portfolio investment in 3rd quarter 2005) (Figure III.3). Other than economics factors mentioned before, some positive non-economic factors assured investors to come such as political stability (democratic general election), government's commitment to eliminate corruption (clean government) and full support from all parties to cabinet (new government).

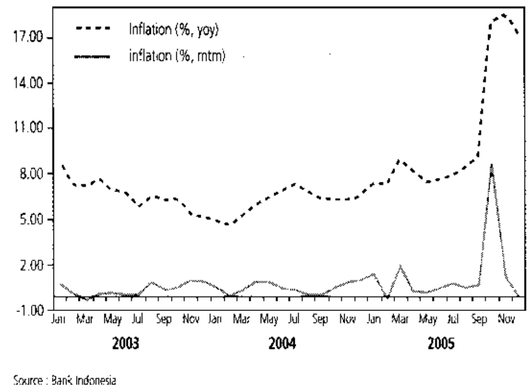


Figure III.1. Inflation Rate

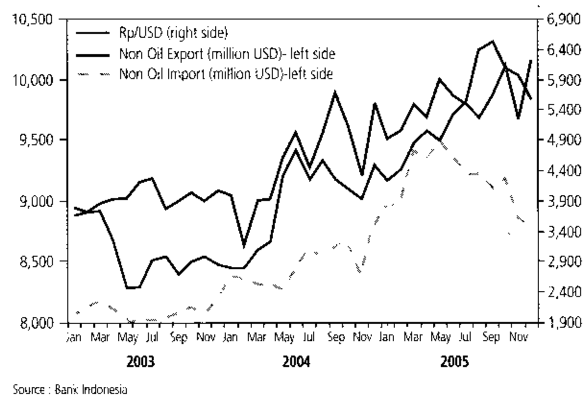
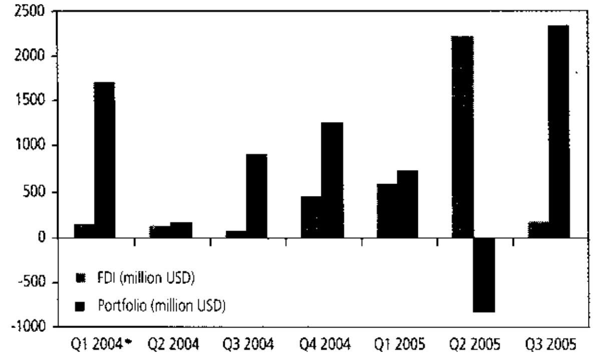


Figure III.2. External Sector

During this promising period, Bank Indonesia, looked as a good opportunity to lowering SBI rate[4] and supporting the real sector. SBI rate went down from 12.69% (January 2003) into just about 7% - 8% in 2004 – up to mid of 2005 followed by a decreased trend in banking credit rate for example working capital rate that eased from above 18% into roughly 13% in the mid of 2005. As a result, the augmented total amount of credit came into the economy with last number reached Rp722 trillion (22% growth y-o-y) (Figure III.4). Accordingly, this high credit growth from banking sectors and controllable macroeconomic condition were the most important engine for high economic growth.

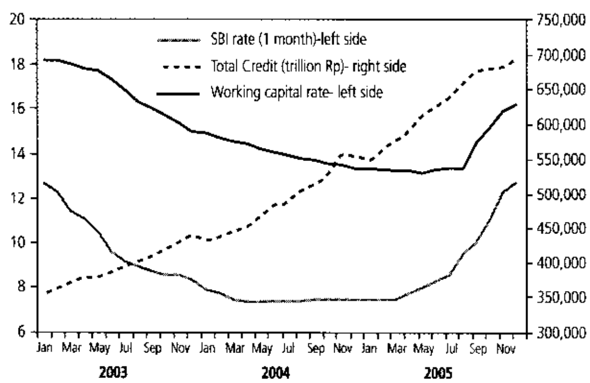
Between period of 1st quarter 2003 to 3rd quarter 2005, GDP grew above 4% (y-o-y) with the highest level at 6.65% (4th quarter 2004) and even it was still over 5% during 2005

4 Guidance for other financial market rate.



Source : Bank Indonesia

Figure III.3. Investment



Source : Bank Indonesia

Figure III.4. Domestic Interest Rate and Total Bank's Credit

(Figure III.5). In detail, GDP was 6.12% (y-o-y) in 1st quarter of 2005, continued to decelerate to 5.84% (y-o-y) in 2nd quarter and 5.34% (y-o-y) 3rd quarter with the overall economic growth of 5.6% in 2005. Furthermore, from economics prospective, the catalyst of the Indonesian economy slowly changed along 2004 – 2005. Right after economic crisis in 1997, consumption side played important role in moving up the Indonesian economy but starting in 2005 investment showed its strong contribution besides also consistent support from export and import sectors (Figure III.6). This was actually a promising signal for future economic expansion.

On the supply side, all sectors in 2005 have also recorded positive growth compared with previous year with 3 sectors recorded the highest growth among others. They were transportation and communication sector, construction sector and electricity, water and air supply sector (Figure III.7). In terms of sectors contribution, GDP growth was supported mainly by agriculture sector, manufacturing sector, and trade sector. Those 3 sectors totally contributed 57.2% in GDP 2005 (Figure III.8).

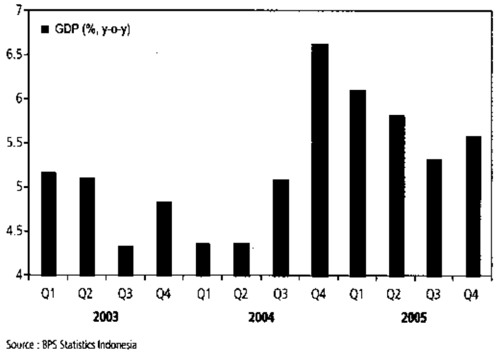


Figure III.5. Econ omic Growth

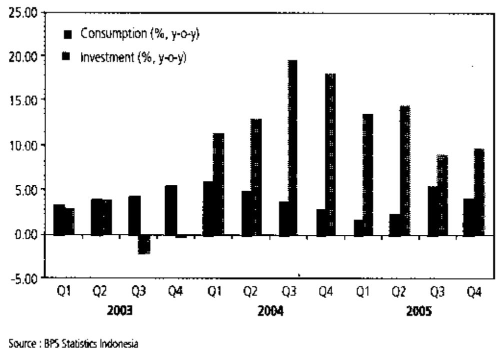


Figure III.6. Consumption Vs Investment

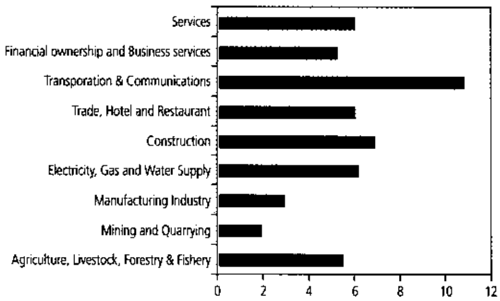


Figure III.7. Economic Growth by Sectors 2005 (%)

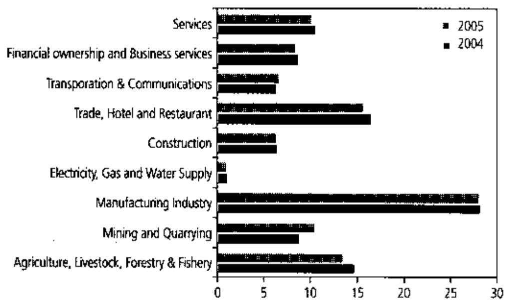


Figure III.8. Sectors Contributions (%)

Table III.1
Some Important Economics Events in 2005

Date	Events
26-Dec-04	Tsunamy tragedy occurred in Aceh and West Sumatera
Jan.17	Infrastructure summit to socialize Indonesia's new strategy for infrastructure development
Jan.25	- Maturity of Hedge Bond (HB) 0077 (value Rp451.97 billion) replaced by VR0031 (value Rp463.6 billion) - Issuence of Fixed Rate (FR) 0027, kupon 9.5%, maturity date June 15, 2015, value Rp5 trillion
Feb.22	Issuence of FR0028, kupon 10%, maturity date July 15, 2017, value Rp3 trillion
Feb.25	Maturity of HB0078 (value Rp451.97 million) replaced by VR0031 (value Rp468.6 billion)
Mar.01	Annoucement and implementation of 29% domestic fuel price hike (1st adjustment)

Table III.1
Some Important Economics Events in 2005 (Lanjutan)

Date	Events
Mar.14	Philip Morris bought 40% of HMSP stock (amounted USD1.8 billion)
Mar.25	Maturity of HB0079 (value Rp451.97 million) replaced by VR0031 (value Rp477.97 billion)
Apr.01	Announcement and implementation of mark to market regulation in capital market by Bapepam
Apr.08	BI bought Rp4.3 trillion Government bond from market.
Apr.13	Issuence of International Bond RI0015, kupon 7.25%, maturity April 20, 2015, value USD1 billion
Apr.15	BI bought again Rp2.2 trillion Government bond from market.
Apr.25	- Maturity of VR0007 with nominal Rp2.95 trillion - Maturity of HB0080 (value Rp451.89 billion) replaced by VR0031 (value Rp487 billion) - Issuence of FR0029, kupon 9.5%, maturity date April 15, 2007, value Rp3 trillion
Apr.27	Agreement (BI and Ministry of State Enterprise) to control demand USD from state owned companies. - Re-opening weekly auction of SBI and implementation of Fine Tune Operation. - Change in NOP from 30% of capital to 20%.
May.15	Maturity of FR0003, FR0008, FR0009 with nominal Rp0.38 trillion, Rp7.51 trillion and Rp5.82 trillion.
May.17	- Issuence of FR0029 (reopening 1), kupon 9.5%, April 15, 2007, value Rp2.1 trillion - Issuence of FR0030, kupon 10.75%, May 15, 2016, value Rp2.5 trillion
May.18	Philip Morris bought 57% of HMSP stock (counted USD5.1 billion)
May.25	Maturity of HB0081(value Rp451.89 billion) replaced by VR0031 (value Rp478.8 billion)
Jun.14	- Issuence of FR0030 (reopening 1), kupon 10.75%, May 15, 2016, value Rp2.78 trillion - Issuence of FR0031, kupon 11%, Nov 15, 2020, value Rp1.05 trillion - BI's circular letter number 7/19/DPNP regarding risk management of banks affiliated in mutual fund.
Jun.25	Maturity of HB0082 (value Rp451.89 billion) replaced by VR0031(value Rp489.38 billion)
June	Taking over HMSP in stock market create positive perception in public.
Jul 05	- BI used Inflation Targeting as monetary policy framework and BI rate as monetary policy signal - Government and BI decided 5 Policies to anticipate weakening of Rp
Jul.11	FR0005 was the most active in market with transaction value Rp758 billion.
Jul.29	Bapepam's circular letter rulling standar deviation for normal market price
Aug.10	- YTM of FR0004 (benchamark 1 year bond) increased from 9.41% to 9.64% - YTM of FR0010 (benchamark 5 years bond) increased from 12.3% to 12.51% - YTM of FR0027 (benchamark 10 years bond) increased to from 11.4% to 12.21%
Aug.23	Bapepam's regulation about registration for underwriters.
Aug.30	- Oil price breach USD60/barrel, IDR weaken to Rp11,800/USD, led BI rate to go up from 8.5% to 8.75% - BI took monetary and banking policies simultenously to protect rupiah
Sep.06	BI announced new policies to protect rupiah and BI rate moved up again from 8.75% to 10%
Sep.26	YTM government bond dropped from 10%-13% to 13.83%-15.86% (1 year)
Sept	FR0015 and FR0005 are the most attractive bond in market
Sept	Investment Companies introduced mutual fund protected
Oct.01	Annoucement and implementation of 126% domestic fuel price hike (2nd adjustment)
Oct.01	The second Bom in Bali
Nov.01	BI rate went up from 11% to 12.25%
Nov.01	October inflation at 8.71% mom or 17.9% yoy
Nov.01	Other Central Banks policies announced to maintain economic stability
Dec.05	Resuffle cabinet, introducing new Ministry of Finance and new Coordinating Ministry of Economics
Dec.06	BI last economic policy in 2005 by raising BI rate from 12.25% to 12.75%

II.2 Healthy Financial Market

II.2.1 Stock Market

There are 2 places where securities are being traded; Jakarta Stock Exchange (JSX) and the new one, Surabaya Stock Exchange (SSX)[5] . As the macroeconomic conditions in the last 2 years (2003-2004) were relatively under controlled, both markets showed sound performances. Jakarta Composite Index (JCI) in 2005 stood at 1,182 (December 2005) up 162.4 point or 18.2% from 2004 with the highest index in 1,192.2 (March 8th, 2005) (Figure III.9). Market capitalization at JSX hiked sharply 17.84% from Rp679.9 trillion last year to Rp801.2 trillion (Table III.2) while SSX's market capitalization also up 14.88% to Rp695.5 trillion in 2005 from Rp605.4 trillion. The increased trend in JCI and market capitalization in JSX was partly driven by very active market activities with average turnover value recorded Rp33.9 trillion in 2005. Another evidence of impressive market activities was from number of market players that counted 336 market players[6] . On the other side, average turnover value in SSX was only Rp0.46 trillion with only 207 market players. Like a year before, JSX market in 2005 was very promising so that attracted foreign investors to place Rp1.5 billion per month on average (Figure III.10).

Some economics factors determined stock market value in 2005 such as movement of world oil price and domestic fuel price adjutmet, Rupiah exchange rate, domestic and international interest rate and of course inflation. Besides those issues, the other non economic factors also appeared, mainly (1) The healthy perception of investors after Standard & Poor's (S&P) improved the rating of global government long term bond from B to B+, including improvement in local bond rating to BB from B+, (2) Indonesia were considered out of the non co-operative countries regarding money laundering and (3) Some Indonesian stocks which were having big capitalization value, very liquid and largely owned by public, were planned to enter ASEAN market.

Table III.2
JSX Stock Market Performance

	Dec.04	Jan.05	Feb.05	Mar.05	Apr.05	May.05	Jun.05	Jul.05
Trade Volume (monthly in billion Rp)	41,81	50,92	36,45	62,67	28,1	26,78	26,6	34,81

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5 Established on June 16th, 1989 based on the Minister of Finance Decree No. 654/KMK.010/1989. The nature of the SSX establishment at that time was to support the Indonesian government program in the capital market field and the development of the economy in the East Region of Indonesia.

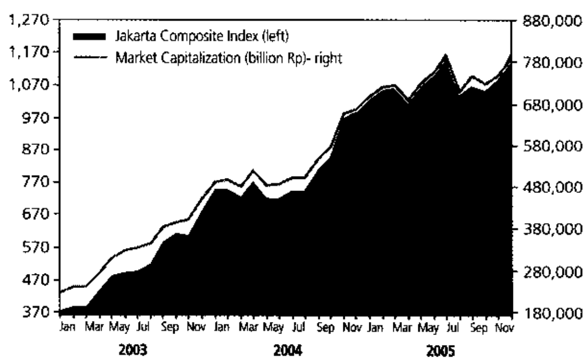
6 Capital Market statistic, December 2005, Bapepam

Table III.2
JSX Stock Market Performance (Lanjutan)

	Dec.04	Jan.05	Feb.05	Mar.05	Apr.05	May.05	Jun.05	Jul.05
Trade Frequency (monthly in thousand unit)	401,75	386,4	373,22	602,25	370,1	257,03	308,68	309,73
Trade Value (monthly in trillion Rp)	30,05	35,21	30,81	70,17	28,04	53,93	25,75	28,17
Market Capitalization (trillion Rp)	679,95	710,37	731,36	735,81	701,83	740,3	765,81	805,45
Number of companies listed	335	334	335	335	335	335	338	338
Jakarta Stock Exchange Index	1000,233	1045,435	1073,828	1080,165	1029,613	1088,169	1122,376	1182,301

Source: Bapepam

For the moment, on a regional basis, the Indonesian stock market -once again- became one of the best performing exchanges, just behind the South Korean markets (up 56.0%) and Japan (up 43.6%) in local currency terms. This compares favorably against the Thai and Malaysian markets, which finished with a gain of 6.9% and a loss of 0.8%, respectively.



Source : CEIC

Figure III.9. JSX Stock Market Performance

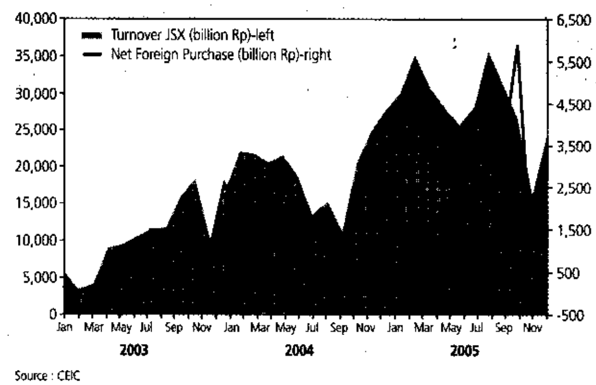


Figure III.10. JSX Turnover and Net Foreign Purchase

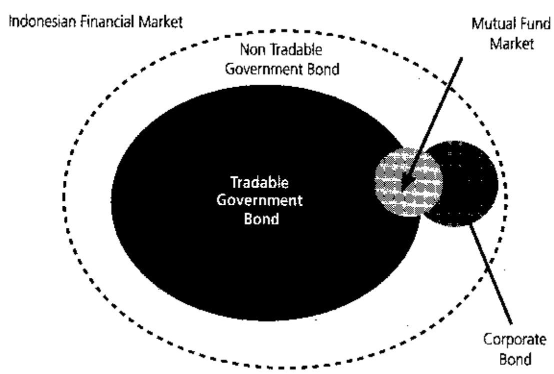
II.2.2 Bond Market

The main focus of this paper is in Indonesian bond market. Among other financial market in the country, bond market was relatively new and its contribution to boost the economy was not so far significant compared with other financial market. Its function firstly was to save banking industry[7] during 1997 economic crisis while lately it became one of financial market investment instruments. Therefore, there are tradable and non tradable bond in the market and the tradable one are the most favorite investment instruments among investment companies in mutual fund market (Picture II). In bond market itself, there are two issuances namely government and corporations. In terms of classification, government has issued debt paper called formally as government debt. Government debt (SUN) is composed of 2 types: (1) Debt Securities and (2) Government Bond. Starting in 1997, government has issued;

A. Debt Securities, issued to Bank Indonesia in order to finance guarantee scheme[8] and loan program. It was being issued to Bank Indonesia on September 25th, 1998. Lastly, up to December 30th, 2005, total amount of debt securities was Rp221 trillion[9] (Table III.3).
B. Government bond, in order to finance banking restructuring program (recapitalization bond[10]) covering Fixed Rate series[11] (FR), Variable Rate series[12] (VR) and Hedged Bond

7 Banks' liquidity problems, restructuring and recapitalization program of banks including stand by fund for guarantee scheme.
8 Government launched guarantee scheme (when bank rush happened) to assure depositors to keep depositing their money at domestic banks.
9 Directorate of Government Securities Management's (DPSUN) release on quarterly report (Dec 30th, 2005).
10 Government issued recapitalization bond program to help banks (during economic crisis) to solve their capital requirement problem.
11 Fixed rate bond pays fixed coupon rate every 6 months.
12 Variable rate bond pays variable coupon every 3 months with coupon rate based on 3 months SBI rate.

series[13] (HB) and this was being issued firstly on May 28th, 1999. The story behind this was when economic crisis (1997), some banks were rushed by their depositors and it harmed up to their capital so the government issued FR bond and VR bond to help them. In addition, government also gave hand to banks that could not match the requirement for their net open position[14] by issuing HB. Both kinds of banks are called recapitalization banks[15]. Lastly, up to December 30th, 2005, total government bond was Rp399.8 trillion with zero HB since June 2005. Therefore, total outstanding of government debt was Rp620.8 trillion[16] (Table III.3).



Picture III.1. Indonesian Bond Market and Mutual Fund Market

Related with redemption case later, according to government debt characteristics, debt securities to Bank Indonesia is non tradable in secondary market, whereas government bonds (excluding HB series) are traded in secondary market[17] and what paper mentions about government bonds is certainly tradable government bond (Picture II). Especially for HB Bond, upon maturity date HB Bond can be redeemed with other government bond series. This background information is so essential as underlying story to know the structure of Indonesian bond market, the size of tradable bond and not all of tradable bond are being traded through mutual fund market.

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13 Since June 2005, all of hedged bond have been replaced with tradable variable bond then no HB existed since June 2005.

14 Net open position means net balance of holding foreign exchange reserve at the end of the day for each bank.

15 Banks which were being recapitalized by Government during the crisis by issuing Government bond.

16 Quarterly report number 2, July 2005, from Directorate of Government Securities Management, Ministry of Finance

17 Government Securities Act number 24, year 2002.

Table III.3
Government Securities Profile (2003 – June 2005) (trillion Rp)

	Dec.03		Dec.05		Jun.05		Mar.05		Dec.04	
	Total	%	Total	%	Total	%	Total	%	Total	%
1 Government Debt Oustanding	623,94	100	621,69	100	630,01	100,00	625,49	100,00	620,86	99,26
A Government Securities*	219,17	35,13	219,68	35,34	219,94	34,91	220,51	35,25	221,03	35,34
B Government Bonda	404,77	64,87	402,01	64,66	410,07	65,09	404,98	64,75	399,83	63,92
a. Fixed Rate	159,04	25,49	178,73	28,75	186,73	29,64	184,5	29,50	189,15	30,24
b. Variable Rate	231,44	37,09	220,57	35,48	221,98	35,23	220,48	35,25	210,68	33,68
c. Hedged	14,29	2,29	2,71	0,44	1,36	0,22	0	0,00	0	0,00
2 Bond Outstanding for trade	623,94	100	621,18	100	630,01	100,00	625,49	100,00	620,86	100,00
A Tradable	390,48	62,58	399,30	64,28	408,71	64,87	404,98	64,75	399,83	63,92
a Fixed Rate	159,04	25,49	220,57	35,51	186,73	29,64	184,5	29,50	189,15	30,24
b Variable Rate	231,44	37,09	178,73	28,77	221,98	35,23	220,48	35,25	210,68	33,68
B Non Tradabale	233,46	37,42	221,88	35,72	221,3	35,13	220,51	35,25	221,03	35,34
a Government Securities*	219,17	35,13	219,17	35,28	219,94	34,91	220,51	35,25	221,03	35,34
b Hedged Bond	14,29	2,29	2,71	0,44	1,36	0,22	0	0	0	0
3 Maturity of Tradable Bond	390,46	100	399,30	100	408,72	100,00	404,98	100,00		
A Less than 1 Year	23,12	5,92	19,69	4,93	37,51	9,18	20,84	5,15		
a Fixed Rate	3,71	0,95	13,71	3,43	28,27	6,92	14,55	3,59		
b Variable Rate	19,41	4,97	5,98	1,50	9,24	2,26	6,29	1,55		
B 1 - 5 Years	121,76	31,18	134,93	33,79	129,13	31,59	137,52	33,96		
a Fixed Rate	46,67	11,95	52,97	13,27	50,43	12,34	58,82	14,52		
b Variable Rate	75,09	19,23	81,96	20,53	78,7	19,26	78,7	19,43		
C 5 - 10 Years	129,42	33,15	129,01	32,31	117	28,63	128,6	31,75		
a Fixed Rate	108,65	27,83	112,05	28,06	100,04	24,48	101,75	25,12		
b Variable Rate	20,77	5,32	16,96	4,2	6,96	4,15	26,85	6,63		
D More than 10 Years	116,16	29,75	115,67	28,97	125,08	30,60	118,02	29,14		
a Fixed Rate	0,00	0,00	0,00	0,00	8	1,96	9,38	2,32		
b Variable Rate	116,16	29,75	115,67	28,97	117,08	28,65	108,64	26,83		
4 Number of Series (unit)	80		58		57		53			
A Government Securities*	4		4		4		4			
B Government Bond	76		54		53		49			
a Fixed Rate	24		23		25		25			
b Variable Rate	28		25		25		24			
c Hedged	24		6		3		0			

Before moving on, based on denomination, government has not only issued Rupiah denominated debt but also in USD denomination. All of debt securities are in Rupiah but some of government bond –mentioned above- are both in Rupiah and USD denomination. Up to now, government has issued 5 series of global government bond[18] totally somewhat USD5 billion. Meanwhile, besides issuing bond to save banks, bonds could actually underpin the development of the financial system by:

a) Serving liquidity for investors and fitting investor preferences for either longer-term or short-term saving products. Expectantly, the long term funds are needed for investment activities.
b) Developing derivative products as the underlying instrument. Primarily, government bond provide pricing benchmarks for other instruments and improve market practices and standards.
c) Market participants would learn from the less-risky government bond to other riskier financial products.

One big question comes into our mind, what caused the progressive development in Indonesian bond market so far? Why it was very attractive to investors? The ultimate factor that pushed the development of bond market was when interest rate persistently went down from 12.7% in 2003 into 7%-8% in mid of 2005, lower than coupon rate offered by fixed rate bond (10%-14%) and corporate bond. As a result, bond market became a very challenging market and the most favorite financial market instruments. One evidence of it was from average market capitalization of government bond which was recorded up 26.5% from Rp391 trillion (2004) into Rp495 trillion (Figure III.11). However, because of redemption, government bond average trading value was slightly down from Rp42.7 trillion (2004) into Rp30.37 trillion (2005) (Figure III.12). Specifically, compared with corporate bond, government bond was a favorite one in the market. Among 50 series of government bond, the most favorite FR bond for investors were FR02, FR04, FR05, FR10 and VR08 for variable rate bond (Figure III.13 and III.14).

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18 Namely Indo 14, Indo 15, Indo 06, Indo 17 and Indo 35. Indo 14 will be mature on March 10th, 2014, while Indo 15' maturity date will be on April 20th, 2015 with valued USD2.5 billion for both global bonds. Regarding Indo 06, it will be due on this coming August 1st, 2006 valued USD0.4 billion. Lastly Indo 17 and Indo 35 was the newest one (issued in 2006) with total amount of USD2 billion and both will mature in 2017 and 2035.

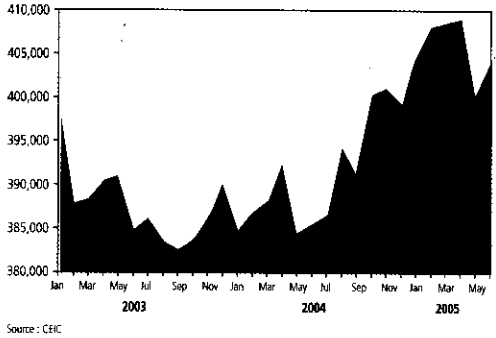


Figure III.11. Market Capitalization in Government Bond (billion Rp)

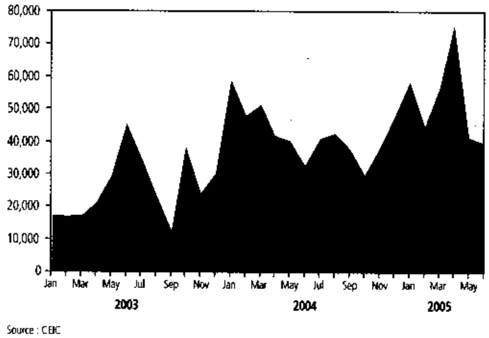


Figure III.12. Trading Value of Government Bond (billion Rp)

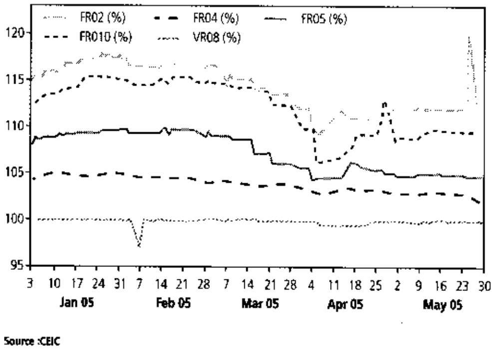


Figure III.13. Price of the Most Active Bonds (%)

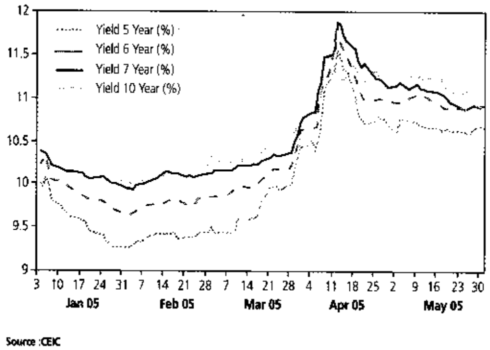


Figure III.14. Yield of the Most Active Bonds (%)

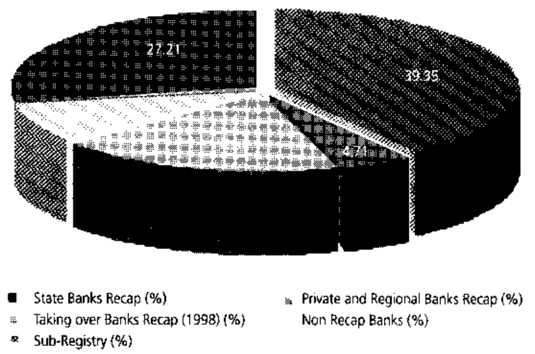
Then, it might be important to know who government bond holders are. They are coming from various entities. Before redemption, from total government bond outstanding in December 2004, state recap banks owned 39.3%, private and regional recap banks owned 4.7%, non-recap banks (8%), take over banks (18.6%), sub registry[19] (27%) (Figure III.15)[20] . By at looking this composition, it is clearly seen that the bond trading activities was mainly done by recap banks, non recap banks and sub registry. Indeed the most active bond market trading was in sub registry with around 100,000 retail investors[21] . Hence, the panic selling explained later was done by these players with Rp5 billion – Rp10 billion normal transactions per day. For information, 27% of sub registry's ownership in government bond was composed of investment companies

19 Insurance companies, pension fund, state enterprises, non resident, investment companies, etc

20 Quarterly report, from Directorate of Government Securities Management, Ministry of Finance (DPSUN).

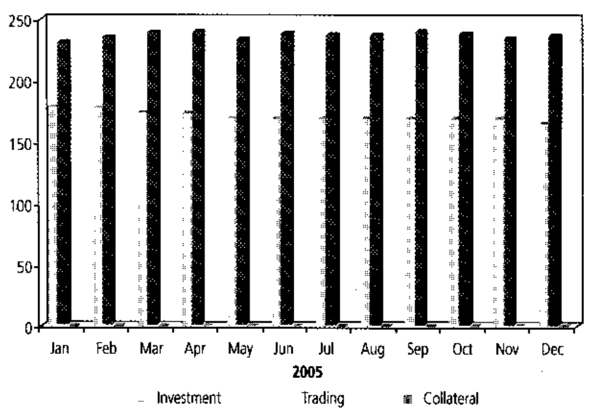
21 Republika (local news paper), September 24th, 2005.

(from mutual fund) which owned 9.57%, pension fund (5%), foreigners (3.62%), insurance companies (7.5%) and others (2.39%). On top of that, bond holders' motives of holding bond were ultimately for trading (58.8%) besides investment (41.1%) and a small part for collateral (0.03%) (Figure III.16). Indeed, these figures showed a promising development in domestic bond market despite of lack of supported supervision and regulation.



Source : DPSUN

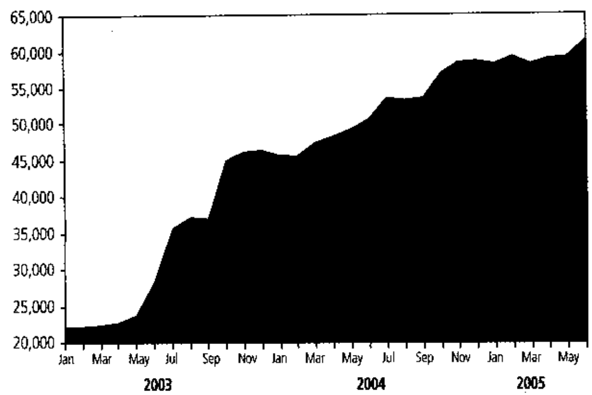
Figure III.15. Government bond Holders (%)



Source : DPSUN

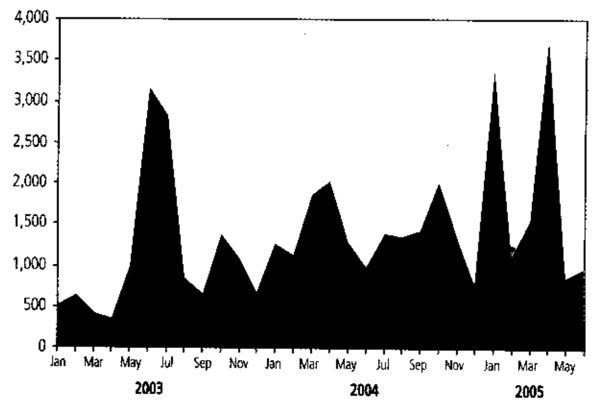
Figure III.16. Government bond Holders (%)

Like government bond, the development of corporate bond sound very healthy. Average market capitalization of corporate bond grew up amazingly 180% from Rp51.7 trillion (2004) into Rp145 trillion (2005), but it was only 30% of government bond (Figure III.17). However, unlike government bond, average trading value of corporate bond grew 60% from Rp1.4 trillion (2004) into Rp2.25 trillion (2005) (Figure III.18). About the issuances, corporate bond in Indonesia was ultimately issued by state banks, big retail companies, big telecommunication companies and some other state owned companies with bond issued in Rupiah and US dollar denomination. Among others, some favorite Rupiah corporate bonds were bonds issued by Bank BNI, Bank Mandiri, Bank BRI, Indofood, Indosat[22] , etc while favorite US dollar corporate bonds were bonds issued by state owned companies and oil companies .



Source : CEIC

Figure III.17. Market Capitalization in Corporate Bond (billion Rp)

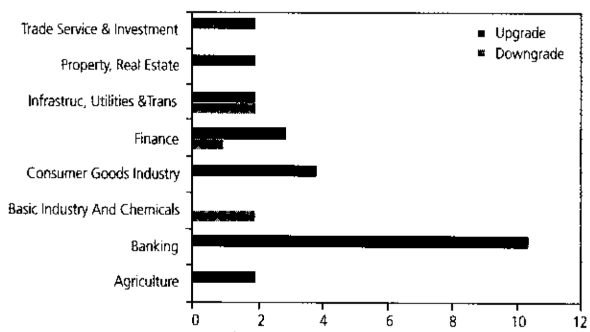


Source : CEIC

Figure III.18. Trading Value of Corporate Bond (billion Rp)

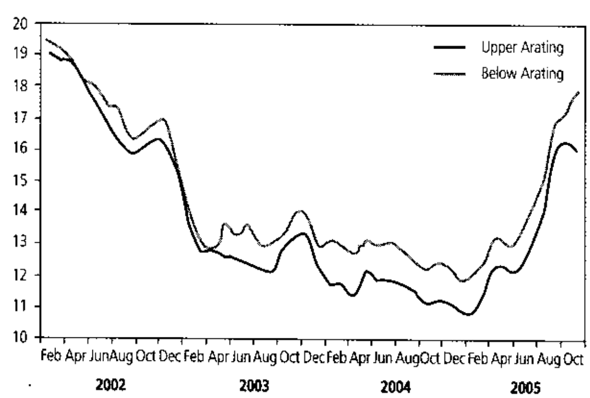
8 Danareksa Yearly Report, January 2006.

Trading activities of corporate bond can not be separated from their ratings as a benchmark to determine bond yield and price. Indonesian corporate bond rating migration along 2005 highlighted more rating upgrades than rating downgrades. The average rating increased to A from A- in the previous year. The good news was that rating upgrades occurred primarily among low grade corporate, such that the gap between the high grade and the low grade corporate declined. Among corporate bond sectors, corporate bond issued by banks continued to dominate rating upgrades followed by finance, consumer goods and construction and property companies (Figure III.19). Factors which underlined rating up grades in banking sectors were due to sound performance of banking sector in the last 2 years either in banking activities or in their function as financial market intermediary. Indeed, this rating influenced the yield of corporate bond which tended to rise along 2005 (Figure III.20).



Source : Bloomberg and Danareksa Sekuritas

Figure III.19. Rating Migration Among Corporate Bonds



Source : Bloomberg and Danareksa Sekuritas

Figure III.20. Yield of Corporate Bond by Rating Category

Talking about benefit side of corporate bond should be followed by risk side. Which corporate bonds were risky? Some market players believed that the riskiest sectors in corporate bonds were the wood and forestry sector. Business risk is very high because the industry has faced difficulties in obtaining supplies of raw materials eventually logs so that bonds of companies in the forestry sector were traded at very deep discounts to yield curve benchmarks. Meanwhile, among the construction bond issuers, there was no major difference in business risks since all the bond issuances were state owned companies and most of them generate revenues mainly from government projects.

II. 2. 3. Mutual Fund Market

Discussing about bond market in Indonesia is inseparable with mutual fund market. Every event in bond market was closely related with mutual fund market and vice versa. Why was that? As describe in previous picture of Indonesian financial market, unlike any other financial markets in Indonesia, mutual fund market was the mirror of bond market since they were placing bulk of their fund in bond instrument. Since 1996, mutual fund market attracted many investors to come especially when they could give higher investment return than return given by banks through banks' deposit. However, besides good story of mutual fund market, the bad story was in 2005's redemption. Mutual fund was the place where redemption occurred and it has not been recovered yet up until now. Of course, this redemption in mutual fund market became also bond market serious problems because what investors withdrew from mutual fund market was bond instruments.

Before coming into redemption case, what factors fueled the high development of mutual fund market in Indonesia in the last 10 years? Five underlying reasons from investors were believed to be mutual fund market growth driven. Firstly, because of the easing trend of interest rate from 12.69% in 2003 to around 7% - 8% in early 2005 caused fixed income instruments (fixed rate bond) more good-looking than variable interest rate based financial market instruments. Secondly, investing money in bank's deposit is taxable with 15% tax on interest rate return. Thirdly, the performance of mutual fund so far could give 34% return on investment to investors and it was extremely high compared with 7%-8% interest rate return offered by banks. Fourthly, investors are strongly attracted with many benefits of investing money in mutual fund explained by fund managers during the promotion. Lastly, market perceived mutual fund as a guaranteed deposit[23] and part of government guarantee schemes like banks' deposit.

23 Due to investment companies' promotion to give higher return than return from banks to investors

Meanwhile, from regulatory and market sides, 5 conditions pushed the development of this market. Firstly, because of low entry barriers to industry; (a) For new comers, the capital requirement is only Rp5 billion and (b) Low standard to be portfolio manager. Secondly, as a new market, naturally mutual fund attracted new players to come and try the market. Certainly, the investment companies enjoy many revenues such as from an advance cost of selling mutual fund products, a daily reward (paid monthly) as fund mangers, profit sharing agreement, etc. Thirdly, the government relieved income tax in the return from mutual fund. Fourthly, government permitted insurance companies to invest 10% of their manageable fund in mutual fund market[24] and lastly lack of enforcement by regulator. As a result, starting from only 25 investment companies in 1996, mutual fund market boomed the industry in 2005 with a number of 328 investment companies and most of them affiliated with banks. Among local players, PT. Mandiri Manajemen Investasi, PT. Trimegah Securities and PT. BNI Securities are the biggest one in terms of manageable fund and there are also big foreign investment companies such as PT. Citibank Securities, PT. Schroders Investment Management Indonesia, etc. In macroeconomic economics point of view, this market so far gives contributions to the Indonesian economy as:

1. Sources of fund for not only market players but also government.
2. New investment alternatives for individual investors, insurance companies, pension fund, etc.
3. Market liquidity and reducing (preventing) capital flight.
4. Benchmark for market players including foreign investors to know market interest.

How was their market performance? Supported by some triggering factors above, during 2003-2005, the net asset value (NAV)[25] in mutual fund market went up doubled from just about Rp50 trillion in early 2003 to reach Rp113.72 trillion in February 2005 (Figure III.21). On average, core portfolio allocation in mutual fund market were 64% in fixed income (bond), 0.95% in stock, 11.24% in money market and 12.69% in mixed[26] investment alternatives (Figure III.22). Nevertheless, instead of superior achievement in mutual fund market, some risks could potentially happen such as: (a) refinancing risk, if the issuances can not pay their obligation, (b) liquidity risk in case of massive redemption, panic selling (c) market risk such as soaring interest rate, exchange rate fluctuation, competition among companies, and (d) guarantee risk meaning that because mutual fund is not under government guarantee scheme so investment companies should be able to anticipate any losses by insuring their manageable fund and finally (e) regulatory risk, such as regulations from related authority: Bapepam, Bank Indonesia

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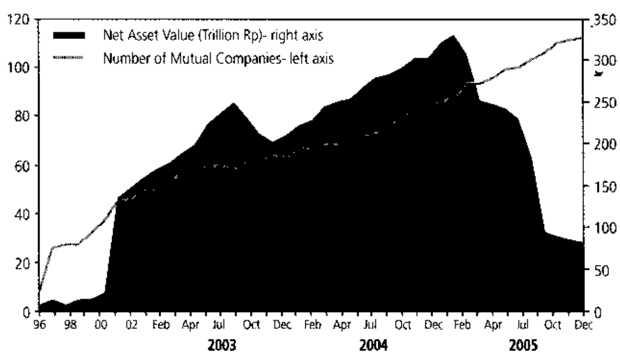
24 In 2005 insurance companies managed Rp60 trillion of fund.

25 NAV is value of portfolio investment after subtracting operational cost.

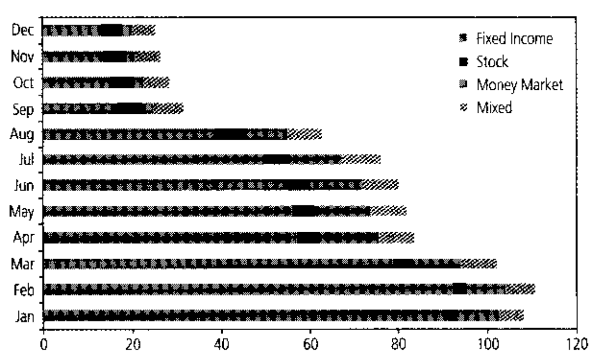
26 Combination of bond and stock, etc.

and Ministry of Finance, for instance mark to market from Bapepam, circular letter (SE no 7/19/ DPNP) from Bank Indonesia regarding implementation of risk management in banks affiliated with investment companies, etc. Therefore, the performance of mutual fund depends on macroeconomic condition, interest rate, capital market regulations, skill of investment managers, investors' perception and investment strategy. However, these risks were not realized by most of mutual fund investors. In line with what fund managers offered during the promotion, investors perceived that mutual fund was a guarantee return deposit and like saving deposit it could be redeemed anytime. Finally, this belief became factors that caused panic selling in mutual fund market.



Source : Bapepam

Figure III.21. Mutual Fund Market Performance



Source : Bapepam

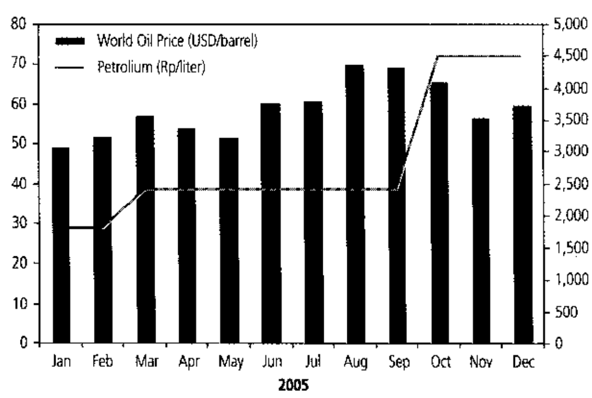
Figure III.22. Mutual Fund Market Portfolio (trillion Rp)

III. World Oil Price Shocks and Its Impact to Redemption

III.1 World Oil Price Hike

What's cause redemption? This paper classifies 2 factors namely macroeconomic factors and market factors. Pressure from macroeconomics damped the economy then finally affected bond market and mutual fund market which had some market weaknesses. So, the redemption story was beginning from the unexpected external shocks occurred in many countries during 2005, unexceptionally Indonesia. The prior healthy economic performance was suddenly hit by world oil price hike besides a little effect from US tight monetary policy (Figure III.23). Specially from the world oil price hike, it gave the biggest impact to the economy because of some fundamental macroeconomic conditions; (1) Indonesia is now net oil importing country, (2) Domestic fuel demand is going up every year, (3) Government still subsidized domestic fuel price (4) Demand of dollar moved up to import oil which also gave pressure on rupiah and inflation (imported inflation), (5) Cost of production was increasing since most of raw materials for finished goods in industries were imported and (6) Smuggling became more frequent because big price differentiation between domestic (subsidized) fuel price and world oil price.

Due that macroeconomic conditions, when world oil price up in August 2005, Rupiah was rapidly under pressure and moved to above Rp11,000/USD from its average level in Rp9200/USD – Rp9800/USD (Figure III.24). This sudden pressure shocked domestic economy. Some factors from external side were also believed to be the driven of pressure to Rupiah such as volatile movement in regional currencies and the increased risk premium on emerging markets. From internal side, some factors were recorded; heightened public concern over fiscal sustainability because high oil price would increase domestic oil subsidy, persistent increased in demand of foreign currency to import oil (Table III.4) and not fully capable monetary policy in anticipating high expectations of inflation.



Source : Pertamina

Figure III.23. World Oil Price

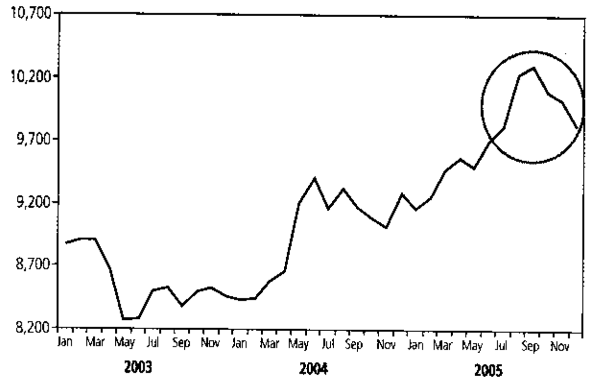


Figure III.24. Rupiah Exchange Rate (Rp/USD)

Table III.4
Indonesian Balance of Payment

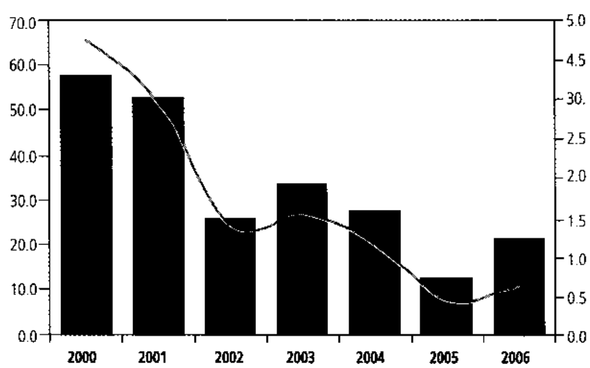
	2000	2001	2002	2003	2004*	2005*
Current Account (million USD)	**7.990**	**6.902**	**7.823**	**8.107**	**3.108**	**367**
Export (fob)						
Non oil and Gas	50.341	44.805	46.307	48.875	54.482	48.713
Oil and Gas	15.066	12.560	12.858	15.234	17.685	14.951
Total Export	65.407	57.365	59.165	64.109	72.167	63.664
Import (fob)						
Non oil and Gas	-34.378	-28.961	-28.990	-31.723	-39.456	-36.218
Oil and Gas	-5.988	-5.707	-6.662	-7.823	-11.159	-12.294
Total Import	-40.366	-34.668	-35.652	-39.546	-50.615	-48.512
Services (net)						
Non oil and Gas	-12.500	-11.501	-11.111	-11.285	-13.155	-10.198
Oil and Gas	-4.551	-4.294	-4.579	-5.171	-5.289	-4.587
Total Services	-17.051	-15.795	-15.690	-16.456	-18.444	-14.785
Capital Account (million USD)	**-7.894**	**-7.617**	**-1.102**	**-950**	**2.613**	**530**
Public Sector						
Official inflow	4.151	2.906	2.366	2.170	3.766	1.490
Debt Repayment	-2.532	-3.005	-2.556	-3.004	-5.543	-3.153
Total Public Sector	1.619	-99	-190	-834	-1.777	-1.663
Private Sector						
FDI	-4.550	-2.977	145	-597	1.023	2.623
Others	-4.963	-4.541	-1.057	481	3.367	-430
Total Private	-9.513	-7.518	-912	-116	4.390	2.193
Total Current and Capital Account	**96**	**-715**	**6.721**	**7.157**	**5.721**	**897**

*Pre Eliminary
Source: Indonesian Global Bond Presentation (Feb 27th, 2006)

Further, oil price hike hurt government Budget (APBN) for 2005 (Figure III.25). With a big hit from world oil price hike to around USD70/barrel in August – September 2005 followed by the consistent increased in domestic fuel demand around 5%-6% per year and USD40-USD50/barrel oil price assumption in APBN 2005, it caused 3 problems for government to be solved;

1) Total subsidy of roughly USD14 billion should be provided (only USD7.65 billion in the budget).
2) Increased demand of dollar from Pertamina[27] , and
3) Strong efforts were needed to eliminate oil smuggling activities.

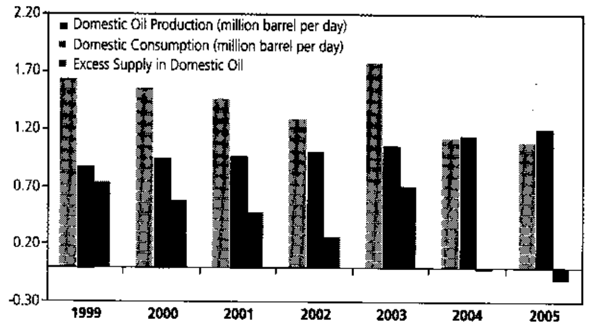
Actually, it became very difficult problems to be solved since on March 1st, 2005[28] , the government had made its first adjustment in domestic fuel price although the impact could be handled so far. Price of fuel also considered as a very sensitive price in domestic economy which could move other prices up such as transportation cost, cost of good sold, operational cost and affected macroeconomic indicators. Importantly, the good reputation and image of the most democratic presidential election ever could down persistently if the government decided to adjust the fuel price for the second time.



Source : Danareksa Research Institute

Figure III.25. Budget Deficit as % of GDP

27 State owned company to ultimately handle supply and demand of domestic oil.
28 President decree number 22, 2005.



Source : Various media (being processed)

Figure III.26. Excess Demand and Supply of Domestic Oil

However, the government should not adjust the domestic fuel price and even it should potentially be a fortunate for the economy if Indonesia was still a net oil exporter country. In reality, the domestic oil production has been slowly decreasing from its best performance ever 1.7 million barrel per day in 1977 to just 1.09 million barrel per day (2005) while on the other side the domestic fuel consumption was about 1.21 million barrel per day (Figure III.26). Thus, there was an excess domestic demand for 0.12 million barrel per day. This condition severely pressed the government to think of 2 tough policies to be chosen;

1) Keep importing oil to match domestic demand with consequence of Rupiah depreciation, soaring inflation and increasing budget deficit as well as hurting fiscal sustainability program, or
2) Adjusting the domestic fuel price to reduce domestic fuel demand as well as rupiah pressure together with easing oil subsidy in APBN but with consequence of inflation and suffering low income people.

Fortunately, if government could anticipate the domestic impact of fuel price adjustment, the adjustment policy would substantially eliminate smuggling. About smuggling itself, former Coordinator Ministry of Economics (Prof. Dr. Dorodjatun Kuntjoro-Jakti) ever mentioned a total amount of Rp56 trillion or USD5.6 billion government lost from smuggling activities every year[29] . Since few years ago, a lot of smuggling cases has been successfully detected and arrested the smugglers but if the oil subsidy still existed, smuggling could not be successfully eliminated. In general, the second alternative was hurting short term economic performance but would guarantee prospective future economic conditions.

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29 Kompas (local News Paper), Feb 16th, 2003

Finally, the government decided to cut fuel subsidy by adjusting the domestic fuel prices for the second times on October 1st, 2005[30] and this decision again, severely increased domestic inflation while it had already been depressed by imported inflation due to depreciation of Rupiah happened before. However, the most important point to be addressed is that the government would not take this tough policy unless the world oil price did not increase, the domestic demand for oil was not increasing continuously, Indonesia was not a net importing oil country and the government did not provide any subsidy for domestic fuel price. In the first fuel price adjustment, all of fuel products except Pertamax Plus and Pertamax[31] was adjusted 29% up on average prices but in the second one, all fuel products (no exception) rose 126% on average (see Appendix a). Nevertheless, the economic impact from first adjustment was relatively lower than the second one as inflation was only up to 8.81% (y-o-y/March 2005) from 7.15% (y-o-y/February 2005) with the sustained of economics growth remained unaffected and the government could save Rp20.2 trillion (USD2 billion) budget on subsidy[32] .

Following the hard policy, both the government and Bank Indonesia has been ready to lessen the impact of the policy and regained the macroeconomic stability. In order to keep maintaining economic growth momentum and lowering Rupiah fluctuations, Bank Indonesia on April 27th, 2005 made an agreement with government (Ministry of State Enterprise) to control demand and supply of dollar from Pertamina. Moreover Bank Indonesia also took some pre-emptive such as[33] : (a) Opening again SBI's weekly auction[34] supported by Fine Tune Operation (FTO)[35] to absorb/inject liquidity from/ into market, (b) Changing net open position (NOP). Previously, requirement for NOP was 30% of banks' capital but right now it was 20% of banks' capital, and lastly (c) Doing swap intervention[36].

Regarding the social impact of the October 1st fuel price adjustment, the government compensated the impact ultimately to keep surviving the needy by providing cross subsidy under 4 programs: Direct cash subsidy (BLT), Scholarship for education, Improving health facilities, and Developing infrastructure in suburb areas (see Appendix III.b). By doing this, the government promised to public that the 2nd fuel price adjustment would only affect the high level income but not the other way around and the budget saved from oil subsidy would be cross allocated to finance government projects in education, health and infrastructures.

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30 President decree number 55, 2005

31 Name of one fuel products from Pertamina.

32 Without 1st fuel price adjustment policy, the Government must provide Rp60 trillion (USD6 billion) subsidy but by doing 1st fuel price adjustment, the Government must only provide Rp39.8 trillion (USD3.98 billion).

33 Bank Indonesia press release April 27th, 2005

34 Since March 2004, SBI auction was held every 2 weeks and in June 2004 it was once a month.

35 FTO is special monetary instrument to fit market liquidity target by Bank Indonesia. It consists of Fine Tune Contraction (FTK) and Fine Tune Expansion (FTE).

36 Although it was allowed to do, the central bank lately never used this mechanism.

As being predicted, once the policy being implemented, the sharp increase in domestic fuel price dragged up the inflation rate from 0.69% (m-t-m) in September 2005 to 8.70% (m-t-m) in October 2005[37] or from 9.06% (y-o-y) in September 2005 to 17.89% (y-o-y) in October 2005[38] . In terms of core inflation, the adjustment caused core inflation to go up to 8.90% (y-o-y) from 6.73% (y-o-y) in September. Besides, huge impacts from the implementation of the 2nd fuel price adjustment, inflation at the same time was also driven by the second round effect of the policy through transportation cost, pressure from seasonal factors (Ramadhan fasting month and Eid-ul-Fitr), exchange rate pass through and expected inflation[39] . For central bank, the core inflation is the demand side inflation to be controlled and responded otherwise it would affect medium inflation target[40] and other macroeconomics indicators. Combined with Rupiah depreciation to above Rp11,000/USD, the central bank finally decided to tightening monetary policy by mounting the BI Rate[41] from 8.5% in July 2005 to 11% in October and lately to 12.75% in December 2005 (Table III.5 and Figure III.27). The most important point to be addressed, Bank Indonesia would not hike interest rate (up to 425 bps in period of July 2005 – December 2005) unless the government adjusted domestic fuel price and the world oil price severely affected inflation and rupiah. Maintaining rupiah stability in terms of inflation and rupiah exchange rate is the ultimate task of Bank Indonesia under the new independent central bank constitution[42] .

Table III.5
BI Rate 2005 (%)

	BI Rate %
5-Jul-05	8,50
9-Aug-05	8,75
30-Aug-05	9,50
6-Sep-05	10,00
4-Oct-05	11,00
1-Nov-05	12,25
6-Dec-05	12,75

Source : Bank Indonesia

37 2.03% (q-t-q) in 3rd quarter 2005 to 11.57% (q-t-q) in 4th quarter 2005.

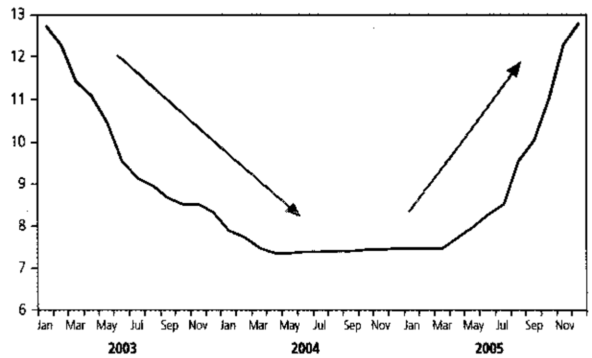
38 Nevertheless, it should also be noted that some neighboring countries, such as Thailand, Malaysia, and India, have also been affected by inflationary pressure driven by high international oil prices.

39 Core inflation is influenced by exchange rate, output gap and expected inflation.

40 Bank Indonesia and Government set 3% for medium and long term inflation target (http://www.bi.go.id).

41 The central bank monetary policy signal, implemented since July 2005

42 Central bank's constitution number 23 year 1999.



Source : Bank Indonesia

Figure III.27. SBI Rate (%)

III.2 Impacts to Financial Market

III.2.1 Stock Market

Luckily, the huge negative impact on the world oil price hike did not totally harm stock market performance in 2005. In one side, the oil price hike gave positive impact to stock market index especially to some stocks from mining companies through additional income but on the other side, it troubled the performance of other market players from different industries. The same with public concerns, investors in stock market concerned the 2 impacts of world oil price hike: (1) it could widen the government budget deficit, but (2) if the government decided to adjust it by escalating domestic fuel prices, it could push short term high inflation. In fact, central bank's policy to raise interest rate depressed some stocks which were interest rate sensitive such as stocks from banks and properties.

Nevertheless, the overall impacts in stock market tended to be neutral since during 2005 there were 2 big acquisition transactions restrained the stock market index to fall. Firstly, on March 14th, 2005, PT. Phillip Morris Indonesia (PMI) bought 40% shares (1.7 billion shares) of PT. HM Sampoerna[43] (HMSP) at Rp10,600 per share or amounted USD1.8 billion[44]. In that time the price of HMSP in stock market went up from Rp8,850 into Rp10,450 in only a day. Secondly, again on May 18th, 2005, PMI purchased 57.5% shares of HMSP from tender offer counted USD2.7 billion. Thus, in total PMI owns 97% of HMSP with total purchase of USD4.5 billion[45].

46 The 2 biggest telecommunication companies in Indonesia.

47 Danareksa Composite Bond Indexes. Danareksa is one of state owned investment companies in Indonesia.

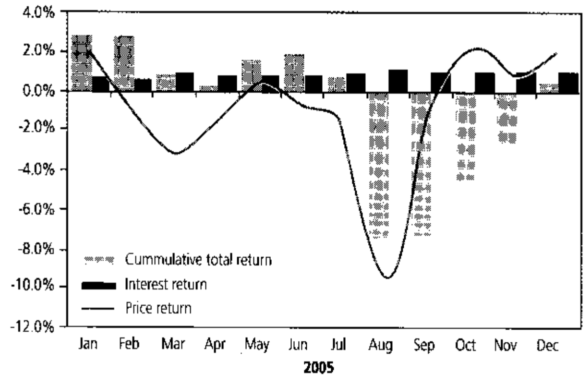
If we look at the stocks performance per sectors, investors seemed carefully placing money in banking stocks due to their credit risk (default) perception in banks. But, on the other hand, they tended to put more fund in agriculture stocks (it grew 61.9%) because agricultures were resistance to Rupiah fluctuation and the good prospect of crude palm oil during 2005. Other stocks from infrastructure sector were also going up because of the increased trend in telecommunication's stocks mainly from Telkom and Indosat[46] . In overall, stock market still grew and remained unaffected by either world oil price hike or domestic fuel price adjustment.

III.2.2 Bond Market

Here, the story begins. The year 2005 did not seem to be good for bond market. The government policy to adjust domestic fuel price two times followed by tight monetary policy from BI has given a big impact on bond market. The bond market performance reached its nadir in August 2005 and continued to the end of 2005 as liquidity dried up due to redemptions happened in mutual fund market. Both policies led to panic selling in government bond holders causing negative total returns for the composite bond index (Figure III.28), dropped in bond price followed by increased bond yield and triggering secondary market transactions to go up due to panic selling activities. Total return during the year was 0.3%, with the negative price returns of 12% close with the interest return of around 12%. This small single digit return came after four years of double digit returns (Figure III.28).

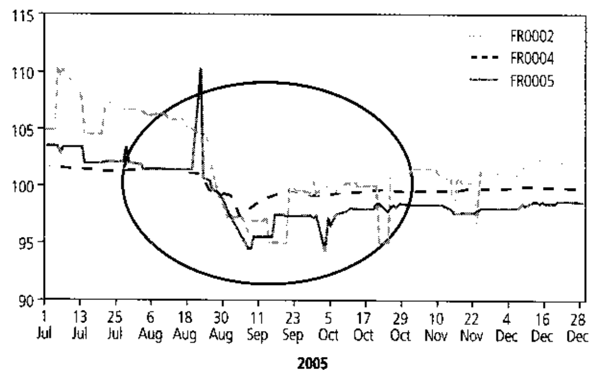
Government bond holders in the panic selling condition sold their bond in with deep discount so that price of government bond fall below its par value. Therefore, price of government bond[48] in the 2nd half of 2005 eased 10% deeper than 4.5% in 1st half 2005. Even before the announcement of the 2nd fuel price adjustment in October 1st, 2005, from April 2005 to August 2005 the investors (who could predict short term monetary policy reactions) have slowly redeemed their bond portfolio from the market. The increased trend of world oil price since early 2005 followed by tight monetary policy in many developed countries combined with limited oil subsidy in government budget and bond market perception that mounting interest rate in September 2005 was too late and it would go up again, has guided investors' perception to surely withdrew bond and put them in the other promising investment instruments. As a result, the deepest fall in bond price happened in August 2005 (5%) and September 8% right before the announcement of 2nd fuel price adjustment. At that moment, almost all of government bond prices reached their lowest value ever during 2005 (Figure III.29).

48 Benchmark in domestic bond market.



Source : Danareksa Bond Index

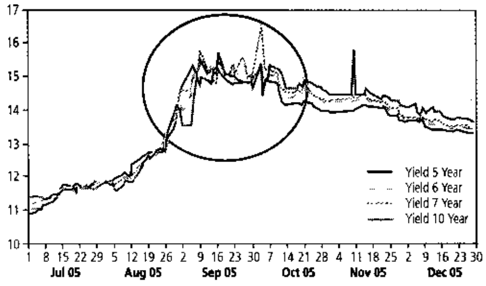
Figure III.28. Danareksa Composite Bond Indexes



Source : CEIC

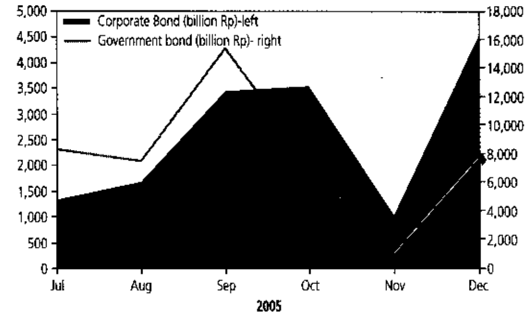
Figure III.29. Price of FR and VR Series in the 2nd Half 2005 (%)

Along with the sudden dropped in bond price, bond yield rose roughly 3.2% - 4% from 11.7% (July 2005) into 15.4% (September 2005) (Figure III.30). However, unlike normal condition, this sharp increase was pushed dominantly by liquidity risks since it was driven primarily by panic selling in bond market. The bond yield was continuously going up as when some of the corporate which issued bond were believe not being able to carry out their obligation. Furthermore, from the spread of bid-ask price of the most traded government bond, it described 2 different conditions when the 1st fuel price adjustment happened and the 2nd one happened. During the 1st fuel price adjustment, the spread were large reflecting bond holders were still in the market and actively trading to re-allocate their portfolio into the best portfolio management. On the other hand, during the 2nd fuel price adjustment, the spread tended to narrow reflecting bond holders were redeeming bond from market by lowering the price in order to re-allocate them into the other promising financial market (Figure III.32, III.33 and III.34).



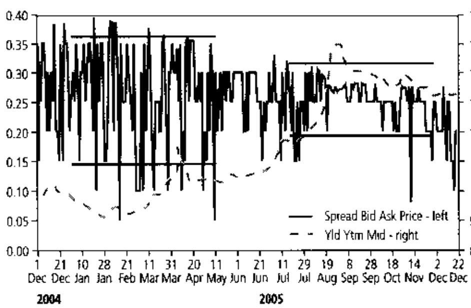
Source : CEIC

Figure III.30. Bond Yield in the 2nd Half 2005 (%)



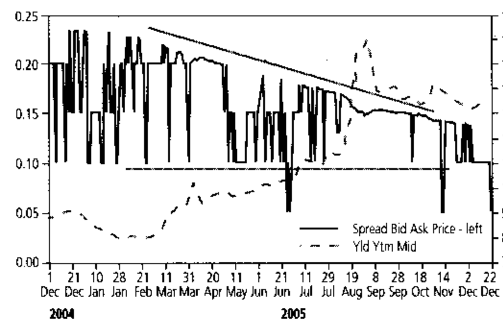
Source : CEIC

Figure III.31. Trading Value in Redemption



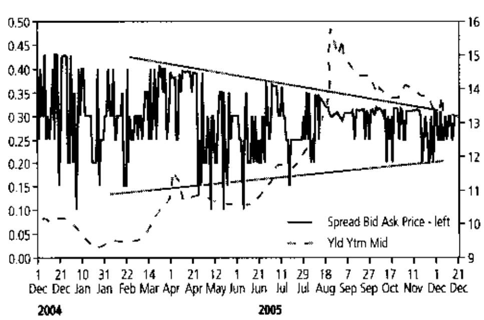
Source : CEIC

Figure III.32. Bid-Ask Spread and YTM of FR 02 (%)



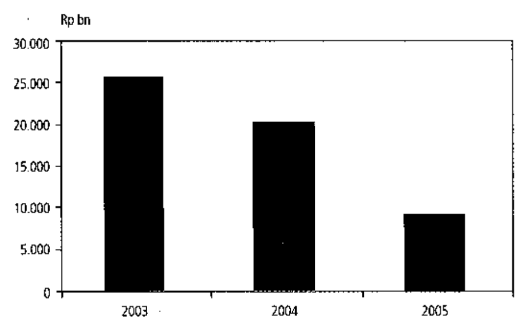
Source : CEIC

Figure III.33. Bid-Ask Spread and YTM of FR 05 (%)



Source : CEIC

Figure III.34. Bid-Ask Spread and YTM of FR 10 (%



Source . SSX and Danareksa Sekurits

Figure III.35. Primary Issuance of IDR Corporate Bonds

Finally, the mass redemption was clearly seen in the high trading activities throughout the year. Before the redemption, trading value of government bond was around Rp7 trillion - Rp8 trillion per month but in the mass redemption period, it reached Rp15 trillion (September 2005). For comparison, the impact of the 1st fuel price adjustment has hiked trading value of government bond to reached Rp79.9 trillion (April 2005) (Figure III.31). The same accident happened in corporate bond. Before mass redemption, its trading value was only around Rp0.8 trillion – Rp1.6 trillion but in redemption period it doubled to Rp3.4 trillion (September 2005) while in April 2005 it was also up to Rp3.7 trillion. However, in October, redemption pressure in government was cooling down reflected by low trading value of Rp7 trillion after some emergency actions had been taken by the authority (Figure III.31).

Continuously, those crest interest rates and negative returns also hit primary market activity. Corporate bond issuance was fairly stagnant entering the second half of the year. They tended not to issue new corporate bond owing to high interest rate and even more than 24 issuers bought back their bond to both save money and get advantage of low bond prices. From bond holder point of view, they wanted to release bond to avoid market risk and default risk of holding corporate bonds. Because of that reasons, along 2005, there were only 5 new corporate bonds compared with 16 new corporate bonds in the year before (Figure III.35). Those new bond issuers were from financial sector (banks) in order to strengthen their equity and from leasing companies to expand their consumer credit. A lack of liquidity caused corporate bonds to trade the bond at deep discounts.

For comparison, the issuance of government bonds fell to just Rp3.06 trillion in 2nd half of 2005, which was far less than 1st half of Rp19.48 trillion. Given the weak local currency bond market, the government switched its fund raising activities to overseas markets and raised USD2.5 billion in two bond issuances in 2005[49]. The increasing risk tolerance toward emerging market financial assets and the lower yield spreads of the emerging market bonds encouraged the Indonesian government and corporate to raise funds from overseas. The yield spread of the Indonesian Yankee bonds to US Treasury Notes, continued to decline, providing alternative fund raising opportunities in the midst of poor local bond market conditions (Figure III.36).

Therefore, instead of redemption case that suffered bond market, there was capital inflow coming in from the issuance of global government bond above. Thus, this positive fact protected Rupiah in foreign exchange market. Since 2004 and even during the 1st and the 2nd fuel price adjustment, there was always excess supply happened in the domestic foreign exchange market

49 April 13th, 2005 and October 5th, 2005.

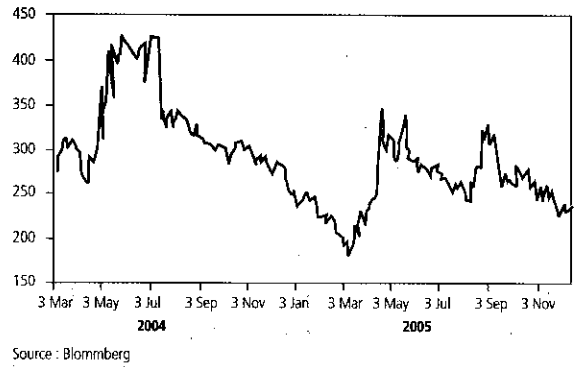


Figure III.36. Bond-Yield Spread Indonesia USD Sovereign

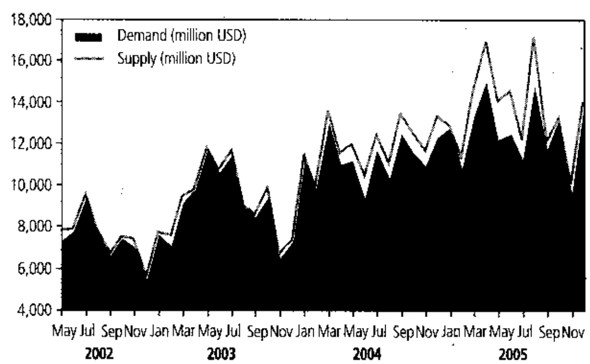


Figure III.37. Domestic Foreign Exchange Market

(Figure III.37). Particularly, in March and April 2005, there were an excess supply of USD1.1 billion and USD1.8 billion respectively. On top of that, August 2005 recorded the highest excess supply in 2005 with USD2.3 billion. This figure explained that government policy to adjust domestic fuel price has decreased domestic demand of oil about 10%-20% per day which finally ended up with less demand for USD in foreign exchange market. Precisely, right after the implementation of 2nd fuel price adjustment, domestic demand of USD was plummeted from USD13.2 billion into USD9.6 billion (November 2005). On the other hand, the cheap bond prices also attracted foreign investors to start buying them causing another capital inflow. Lately, Rupiah seemed not affected with the redemption case and even tended to appreciate up to end of the year because of less demand of dollar, capital inflow and public positive impression to the fuel price adjustment taken by the government (Figure III.38).

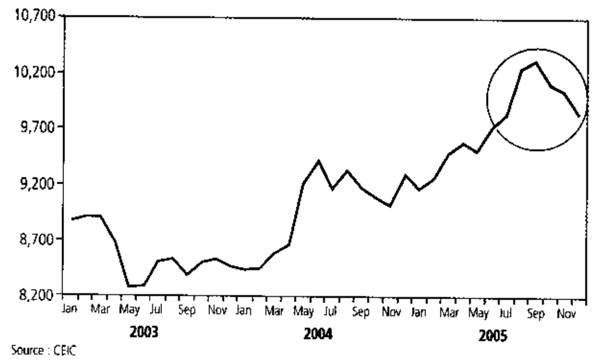


Figure III.38. Rupiah Exchange Rate

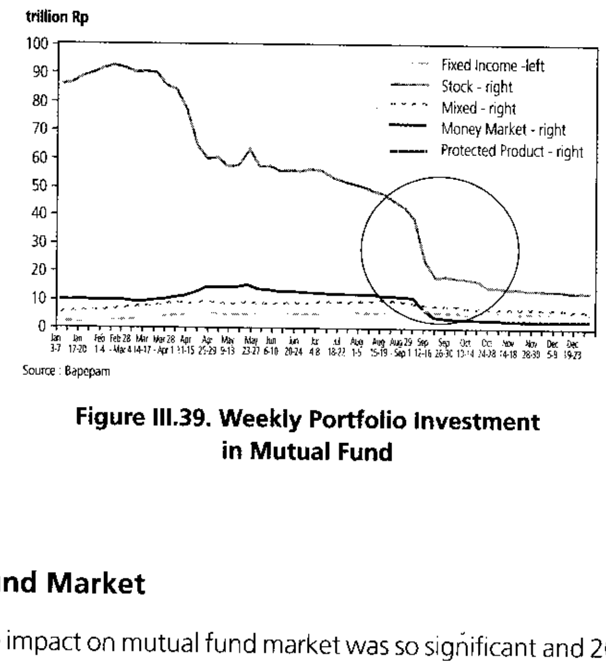
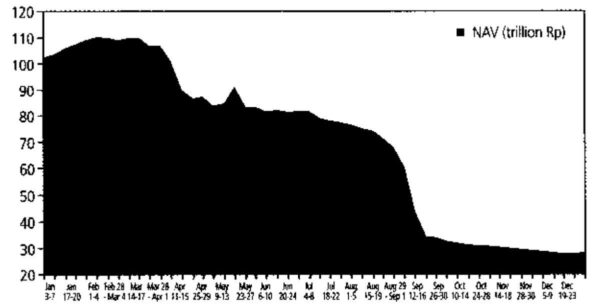


Figure III.39. Weekly Portfolio Investment in Mutual Fund

III.2.3 Mutual Fund Market

No doubt, the impact on mutual fund market was so significant and 2005 was also a tough year in Indonesian mutual fund industry. The impressive achievement in the last 10 years plummeted in only 10 months. Actually as mentioned before, since mutual fund market was a mirror of bond market, so investors' low trust of holding government bond has led to short term panic selling of this instrument in mutual fund market. Previously, net asset value boosted to more than Rp100 trillion at the end of 2004 and kept going up until the first 2 months of 2005, but since the government adjusted domestic fuel price two times, it went down persistently starting from March 28th, 2005 to December 29th, 2005 suffering a cumulative drop of Rp85.34 trillion. In particular, March 28th – April 1st, 2005 was the starting week of the impact of the 1st fuel adjustment which led to small redemption (Figure III.39). During March 28th – April 1st, 2005 itself, NAV was down Rp6 trillion while for the whole month of March 2005, NAV was dropped Rp8.34 trillion from Rp113.7 trillion (February 2005) to Rp105 trillion. Following that, in April 2005, redemption continued to push NAV down about Rp18.93 trillion respectively (Figure III.40).



Source : Bapepam

Figure III.40. Weekly Net Asset Value

Fortunately in this time, some investors just switched their portfolio from fixed income instruments to other instruments which could give them more return. For example, mutual fund investors from HSBC Securities switched their fund from long term instruments (bond) into short term instruments (money market) then, HCBS's portfolio became 40% money market, 30% fixed income and 30% mixed[50] . In March alone, investors withdrew their bond (Rp13.34 trillion redemption) to be newly allocated in stock market (Rp1.59 trillion injection)-to buy mining stocks, in money market (Rp1.83 trillion injection)- to gain from interest rate- and in mixed (Rp1.43 trillion injection) (Table III.7). The same case occurred in following month, investors throwing out bond (Rp21.72 trillion) to be invested mostly in money market (Rp3.17 trillion). Totally, between March–April 2005, bond was redeemed Rp35 trillion but on the other side, new injection happened in money market in about Rp5 trillion, stock market Rp1.64 trillion, and mixed Rp1.22 trillion (Table III.7). Actually in mutual fund market view, this case did not give a serious impact except they had to re-design the best portfolio investment strategy under new circumstances.

However, when the world oil price hike became a big issue in public and the rumors of the 2nd fuel price adjustment by the government was getting frequent in early August 2005, mutual fund investors has slowly anticipated future condition by throwing away their money from the mutual fund market. Therefore, August 1st – 5th, 2005 was the starting week of the second fuel price adjustment impact which led to continuous redemption up to December 2005 (Figure III.39). During August 1st – 5th, 2005 itself, NAV was down Rp1.2 trillion while for

50 Republika (local news paper), July 7th, 2005

the whole month of August 2005, it fell Rp16 trillion with bond as the most investment instrument being redeemed for about Rp11 trillion. The same thing occurred in the following month with a bigger redemption of Rp30.24 trillion, particularly Rp22.7 trillion in bond, Rp7.4 trillion in money market and Rp1.24 trillion in mixed instruments (Table III.7). In the peak hit (August – September 2005), NAV was dropped by Rp46.2 trillion and this removal occurred to all types of portfolio placement, primarily in bond (Table III.6). Bond was totally redeemed by Rp33.8 trillion followed by money market Rp9 trillion and mixed Rp2.14 trillion.

Table III.6
Portfolio Investment in Mutual Fund (trillion Rp)[51]

2005	Fixed Income	Stock	Money Market	Mixed	NAV
Jan	90,99	2,28	9,4	5,55	110,12
Feb	92,26	2,95	8,89	6,68	113,72
Mar	78,92	4,54	10,72	8,11	105,38
Apr	57,2	4,59	13,89	7,9	86,45
May	56,06	5,05	12,84	8,07	84,93
Jun	55,15	5,03	11,74	8,25	83,29
Jul	50,26	5,35	11,67	8,83	78,93
Aug	39,19	5,78	10,07	7,93	62,97
Sep	16,46	5,78	2,63	6,69	32,74
Oct	14,8	5,39	2,25	6,08	30,91
Nov	13,45	5,33	1,95	5,85	29,57
Dec	12,97	4,93	2,08	5,39	28,39

Source : Bapepam

Table III.7
Switching Portfolio (trillion Rp)[52]

2005	Fixed Income	Stock	Money Market	Mixed	NAV
Jan	6,08	0,4	4,767	-3,87	6,10
Feb	1,27	0,67	-0,51	1,13	3,60
Mar	-13,34	1,59	1,83	1,43	-8,34
Apr	-21,72	0,05	3,17	-0,21	-18,93
May	-1,14	0,46	-1,05	0,17	-1,52
Jun	-0,91	-0,02	-1,1	0,18	-1,64
Jul	-4,89	0,32	-0,07	0,58	-4,37
Aug	-11,07	0,43	-1,6	-0,9	-15,95
Sep	-22,73	0	-7,44	-1,24	-30,24
Oct	-1,66	-0,39	-0,38	-0,61	-1,82
Nov	-1,35	-0,06	-0,3	-0,23	-1,34
Dec	-0,48	-0,4	0,13	-0,46	-1,19

Source : Bapepam

51 Flows data at the end of each month.

52 Plus sign means subscription and negative sign means redemption.

Unfortunately, unlike March-April where investors just switched their portfolio, in the second one the investors fully withdrew fund and allocated it themselves out of mutual fund industry. Coupon rate of 9.5% to 11% paid by some FR bonds were less attractive than deposit rate offered by banks due to increased trend in monetary policy rate (BI rate). In addition, allocating money in prospective stock market performance and buying SBI from secondary market with zero risk were also promising investment alternatives in investors' perspective (Figure III.42). Therefore, in order to save mutual fund market, retain bond market liquidity, and restore public trust, Bank Indonesia bought government bond from secondary market. Bank Indonesia firstly bought Rp4.3 trillion on April 8th, 2005, then Rp2.2 trillion on April 15th, 2005 respectively and especially in the second redemption case, Bank Indonesia purchased Rp3 trillion bond. Not only central bank, government (ministry of finance) bought back some series of government bond amounted Rp2.5 trillion[53] , several state owned banks were also helped their affiliated investment companies by purchasing their bond, injecting money under bond repurchase transaction or just lending money under bilateral commitment. Some investment companies took another alternative to keep holding their customers by offering a guaranteed portfolio investment to investors other than redeeming the fund. These were efforts to reduce price volatility in bond market, to re-convincing mutual fund investors and to lowering panic selling.

Fortunately, there was positive response from mutual fund market as the panic selling was cooling down to just Rp1.8 trillion. Redemption in bond was only Rp1.6 trillion much smaller than the one in August 2005 or September 2005. Others (money market, stock market and mixed) felt the same condition. Finally, up to end of 2005, NAV value was left Rp28.4 trillion with accumulative withdrawal from August 2005 to December 2005 recorded Rp50.54 trillion. These facts displayed a higher total amount of redemption than subscription since March 2005 and needed a strong effort from either investment companies in mutual fund market or related parties to recover and get back to its best performance ever (Figure III.41).

Where did the money go? For investors who already took their investment from mutual fund, most of them put the money in banks as reflected by the increased trend of banks' total deposit along 2005 and SBI. Total deposit in banking industry raised 25.8% from Rp731.9 trillion in January 2005 to Rp921.3 trillion in December 2005. Indifferently, total SBI owned by either domestic resident or foreign resident also hiked for about 47.2% (domestic ownership) to reach Rp9.8 trillion and 41.4% (foreign ownership) to reach Rp14.7 trillion. Especially for

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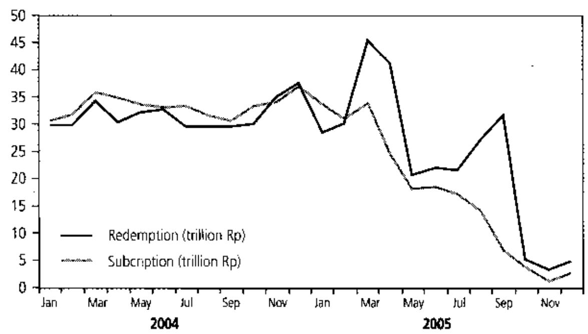
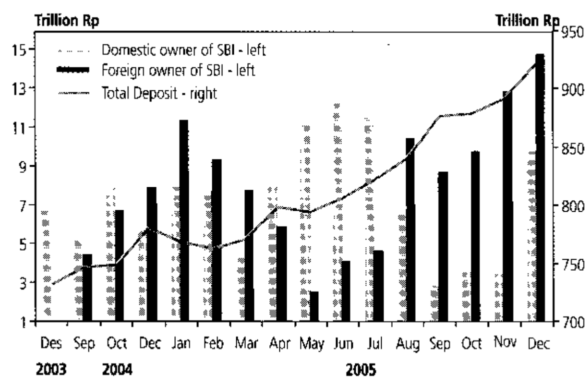
53 Some of FR02, FR04, VR09, VR10, VR11, FR29, FR05, VR12, VR13, VR14, VR15 and VR16 (Suara Merdeka (local news paper)) October 25th, 2005.

foreign buyer, purchasing SBI in primary market is non taxable. Back to banks' deposit, during mass redemption in mutual fund market, total deposit in banks was up Rp20 trillion (August 2005) and Rp35.5 trillion (September 2005) while since August 2005 to December 2005 banks' deposit has been up almost Rp100 trillion bigger than Rp85.34 trillion total redemption fund in that period. Indeed, this figure explained clearly that banking industry has absorbed a lot of money not only as a result of redemption case in mutual fund market but also from other market as well (Figure III. 42).



Source : Bapepam

Figure III.41. Redemption Vs Subscription in Mutual Fund Market



Source : Bank Indonesia

Figure III.42. Total Deposit in Banking Industry

The big question was what cause mass redemption from market factors? As mentioned early, bond market and mutual fund market were having some weaknesses. Those weaknesses were realized right after the mounted of interest rate combined with Bapepam's marked to market regulation[54] for standard valuation in capital market[55] . Weaknesses in mutual fund market which underlined massive redemption are classified in 6 factors.

1. The understanding of investment managers and investors regarding mutual fund market were still poor as well as their analyses of market up date. One factor addressing this was from asymmetric information from investment companies to investors which only pointed out return without warning any risks.
2. Investors and investment managers seemed not ready with daily volatility in NAV (especially bond) as the impact of interest rate hike. Investors only thought one thing: redemption and panic selling or it would be late.
3. Redemption fee only applied to some products, so investors happily redeemed their portfolio.
4. No specific rule of time for redemption so redemption happened at T+0, T+1, T+2 instead of T+7.
5. Mutual fund investors were so attracted with forward deposit product[56] with 12%-16% rate of return offered by foreign banks. It has been moved the fund slightly Rp68 trillion[57] .
6. Basic characteristics of mutual fund investors[58] are (1) Very sensitive and reactive to daily volatility of NAV, (2) Short term view of investment (deposit type of investment) (3) Realizing mutual fund risk but were not willing to accept it (4) Never felt a sudden dropped in bond price before (up to March 2005) and even pretty sure that mutual fund was under government protection scheme.

This case actually became an important issue to be concerned by central bank and government as almost all of investment companies were affiliated with banks. Among all investment companies, the worst impact occurred to PT. Mandiri Manajemen Investasi (MMI)[59] a subsidiary firm of PT. Bank Mandiri[60] , PT. BNI Securities a subsidiary firm of PT. Bank BNI[61] and PT. Trimegah Securities[62]. Previously, PT. MMI managed Rp24.5 trillion (January 2005) but after redemption it was down to Rp0.6 trillion (December 2005), PT. BNI Securities managed Rp9.1 trillion (January 2005) and dropped to Rp1.2 trillion and PT. Trimegah Securities managed Rp12.1 trillion (Januari 2005) and fell to Rp2.5 trillion. Others investment companies felt the same condition. During redemption, other than returning in cash, some investment companies used

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54 Mark to market means Net asset value per unit and it was implemented in April 1st, 2005.

55 Mark to market means that valuing chosen portfolio based on real market price because many investment managers have a tendency to cheat investors by hiding market price in order to get escalating portfolio value.

56 Mixed product that combined regular deposit and forward transaction in foreign exchange market.

57 Republika (local news paper) September 15th, 2005.

58 Household, individual and firms

59 Established in December 2004.

60 The biggest bank in Indonesia with total asset around Rp247 trillion.

61 One of the biggest banks in Indonesia with total asset around Rp147 trillion.

62 Article in Warta Ekonomi (local magazine) on February 24th, 2006 titled Manajer Investasi: Mereka yang tampil beda. http://www.wartaekonomi.com/

other schemes to return the money such as settlement of asset, protected mutual fund products conversion and banks' deposit conversion.

However, small number of investment companies was not affected by redemption such as PT. Fortis Investment Indonesia (FII) which could increased their fund from Rp93.7 billion (2004) into Rp323.8 billion, followed by PT. Mahanusa Investment Management (MIM) with an increased in fund from Rp740 billion (2004) into Rp744 billion and PT. Schroders Investment Management Indonesia which managing Rp9.6 trillion (2005) from only Rp8.2 trillion a year before. Investors in these companies seem to be long term investors with deep understanding of investing money in bond market and perceiving foreign investment companies more credible than local investment companies.

Most of investment companies in mutual fund market believe that mutual fund market in 2006 will still be promising and last year mass redemption gave good lessons to both market players and investors. After the redemption case, investment companies try to improve their performance, ethic as well as professionalism, some new regulation and new system have been implemented by market authorities and investors had been educated by the redemption case and more realize that investing money in mutual fund is a long term investment. In general, the extreme handicapped to recover mutual fund industry may be coming from level of interest rate which is still high and re-convincing the investors to come again in the market after having lost 2 times in 2005. In order to further convince the investors, 6 investment companies (ABN Amro Securities, BNI Securities, PNM Securities, Schroders Securities, Danareksa Investment Management and Trimegah Securities)[63] introduced protected mutual fund product which guarantees the initial investment of the investors through portfolio management scheme. Under this new product, investors' fund is being locked for a certain time (3 months or more) and there is around 5% penalty if redeeming it before its agreement date. Nonetheless, protected mutual fund still has uncertainty in terms of what products guarantee it, who is going to protect it and the ability of fund managers to do that.

Market predicts that the starting point of recovery period will be in the second quarter of 2006 although it won't be too much improvement and year on year growth will be around 10%-15%. Some assumptions underline the prediction such as lower interest rate after second semester of 2006, following low inflation and consistent growth of stock market during 2006. The ideal interest rate for movement of mutual fund market is less 2%-3% than its current level. Moreover, the guarantee scheme will be removed in 2007 causing investors to think of mutual fund as their prospective investment alternative.

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63 Republika (local News Paper), September 2005.

V. Policy Taken by Central Banks and Government

IV.1 Economic, Monetary and Banking Policies from BI

In August 2005, when Rupiah suddenly being under pressure, central bank took immediate measures in monetary policy to bring it under control and restore public confidence. Bank Indonesia in its Board of Governors meeting[64] immediately implemented monetary and baking polices simultaneously. In the first stage, Bank Indonesia raised BI rate by 75 bps to 9.5% and 7-day FASBI rate by 100 bps to 8.5%. Regarding monetary operation, Bank Indonesia would maximally absorb liquidity through fine tuning operations (FTO) and increase maximum deposit guarantee[65] rates in September 2005: In banking sector, Bank Indonesia improved Rupiah statutory reserve requirement based on the lending performance of each bank reflected in Loan to Deposit Ratio (LDR). In second stage, Bank Indonesia provided swap facility for hedging purposes, foreign exchange market intervention and further improvements to prudential regulations governing foreign exchange transactions. In addition, more intensive supervision of banks in regard to currency trading not backed by underlying transactions[66].

Subsequently, in September 2005 to go further stabilizing macroeconomics conditions, Bank Indonesia strengthened its previous policies[67] by deciding 2 policies (1) Raising the BI rate 50 basis points to 10.0% and (2) instituting exchange rate policies by setting ban on Rupiah transactions against all foreign currencies, launching foreign currency swap interventions[68] as an instrument in Open Market Operations, providing swap facilities for currency risk hedging and amending Net Open Position (NOP) regulations.

Furthermore, when inflation in October 2005 was extremely high, besides raising BI rate 125 bps from 11% to 12.25%[69], Bank Indonesia also conducted other policies to stabilize macroeconomic conditions[70] such as extending the windows for the O/N FASBI[71] and always updating its assessment of the economy and deciding policy adjustments if necessary. Finally at the end of 2005, Bank Indonesia[72] took final economic and monetary policies which strongly

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64 Bank Indonesia Press Release on August 30th, 2005.

65 Since economic crisis (1997), Government has set maximum rate of deposit to be guaranteed by Government (under deposit guarantee
scheme) in order to keep people depositing their money in local banks (preventing banks rush).

66 Each banks should report the purpose of their foreign exchange transactions every day to BI.

67 Bank Indonesia press release September 6th, 2005

68 Although it was allowed to do, the central bank lately never used this mechanism.

69 On November 1st, 2005

70 Bank Indonesia press release November 1th, 2005

71 FASBI O/N rate was set at 500 bps below the BI Rate.

72 Board of Governors meeting on December 6th, 2005.

related with all financial market and other economics parties[73] . Bank Indonesia kept holding tight bias monetary policy stance and decided to raise the BI Rate by 50 basis points (bps) to 12.75%. The rise in the BI Rate was regarded as commensurate with efforts to sustain the pace of economic recovery and was seen as sufficient to maintain stability in financial market conditions.

IV.2 Specific Policy Responds Related to Mutual Fund and Bond Market.

IV.2.1 From Bank Indonesia

As mentioned previously, in order to save mutual fund market and retain bond market liquidity, Bank Indonesia bought government bond from market. So far, until December 2005, Bank Indonesia held Rp10.5 trillion government bond and plans to go on buying it every year. Likewise, Bank Indonesia kept holding government bond to stabilize bond market and part of BI's future plan to use government bond as monetary instrument. In addition, because most of investment companies owned by banks and in order to minimize risks related to mutual fund activities, Bank Indonesia issued circular letter (SE no 7/19/DPNP) on June 14th, 2005 regarding implementation of risk management in banks affiliated with investment companies. Some important points were (a) investment managers should have been registered and got license from Bapepam (b) portfolio investments have already fit the instrument requirement from Bapepam[74] (c) Banks have to be involved in identifying, measuring, supervising and managing risk related in mutual fund market (d) Banks were not allowed to create banks product in their investment companies[75] (e) Banks are not allowed to invest in stock market through their investment companies (f) Together with investment companies, banks have to analyze the best and secure portfolio investment offered to public (g) Banks have to regularly report the performance of their investment companies and (h) Sanctions for banks which violate, would be warning wittingly, be frozen or dismissed.

IV.2.2 From Bapepam

Firstly, Bapepam functions are to implement orderly, fair, and efficient capital market activities and protect the interests of investor and public[76]. Moreover, it provides guidance,

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73 Bank Indonesia press release December 6th, 2005

74 Bapepam has set certain investment instruments that can be used in capital market by investment companies.

76 Particularly, according to article 3 Minister of Finance Decree No:503/KMK.01/1997, Bapepam's ultimate tasks are : Drafting Capital Market rules and regulations; Guiding and supervising any Person granted business license; approval, registration from Bapepam and other Person related to Capital Market; Establishing disclosure principles for Issuers and Public Companies; Settlement of the objection by Person imposed sanction by Stock Exchange; Clearing Guarantee Corporation; Central Securities Depositary and Establishing Capital Market accounting standards.

regulation, and day-to-day supervision in capital market and primarily obtains a strong legal foundation for enforcement actions and a more important role in capital market development[77] . In the case of the 2005's capital market instability, Bapepam issued some regulation related to mutual fund market and bond market as follows:

1. Regulation number IV.C.2 appendix head of Bapepam decree number: Kep-24/PM/2004[78] regarding determining normal market value in portfolio investment. In this regulation, each investment manager must determine normal market value based on reference price.
2. Regulation number VIII.C.1 (August 23rd, 2005) regarding registration for underwriters which operate in capital market.
3. Circular letter, SE-02/PM/2005 (June 9th, 2005) and SE-03/PM/2005 (July 29th, 2005) ruling the standard deviation of normal market price being traded in over the counter either government bond or corporate bond.
4. Regulation number IV.C.4 appendix head of Bapepam decree number: Kep-08/PM/2005[79] setting standard for managing structured portfolio investment[80]. Bapepam ruled that investment companies are not allowed to buy securities from their affiliated companies except it is government affiliation; registered protected, guaranteed and indexed portfolio investment are obliged to be reported to Bapepam; limited time and amount of protected, guaranteed and indexed portfolio investment to be offered to public; protected, guaranteed and indexed portfolio investment are obliged to inform their underwriter; and some additional actions should be done if investment companies want to issue protected portfolio investment, guaranteed portfolio investment and indexed portfolio investment.

For the time being, in case of huge redemption and short term demand of liquidity, the government[81] has prepared Master of Repurchase Agreement (MRA) that ruling mechanism for depositing and withdrawing fund in mutual fund market. MRA hopefully could guarantee investors and avoid panic selling due to rumor of unsolved liquidity problem in mutual fund or bond market. Moreover, Bapepam and Central Securities Depository Institution (PT. KSEI)[82] is now developing central fund hub (C-trust) which will arrange the report of mutual fund activities under one roof (KSEI) and it will also support the clean and transparent transaction in mutual

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77 According to the Law of the Republic of Indonesia No. 8 in year 1995 concerning the Capital Market.

78 August 19th, 2004

79 July 29th, 2005

80 Consisting (a) Protected portfolio investment (b) Guaranteed portfolio investment and (c) Indexed portfolio investment

81 Cooperation among Bank Indonesia, Bapepam, Ministry of Finance and Government bond trader association (Himdasun).

82 PT. KSEI is part of the Indonesian Capital Market Community that functions as Central Securities Depository Institution in accordance with Law number 8 of 1995 on capital market. The function of CSD is to provide orderly, appropriate and efficient central custodian and transaction settlement services. In the institutional structure of Indonesian capital market, CSD stands among other self regulatory organization besides Stock Exchange and Clearing and Guarantee Institution.

fund market. Technically, C-trust will efficiently integrated data entry and safe data in one place that all investment companies and depository banks with e-monitoring can access on-line this system easily. Not only that, the investors may also monitor their portfolio investment in many investment companies on-line. Additionally, in the redemption period Bapepam investigated 4 investment companies that were suspected violating the regulations. For other investment companies, Bapepam investigated whether they were informing benefit and risks when offering their products and using market value in valuing their portfolio asset. Lastly, Bapepam and related authority are preparing to implement some other new regulation in the near future such as restricting license for new investment companies, limiting manageable fund based on companies' capital, increasing cash requirement ,

IV.2.3 From Market Players (Investment Companies).

For now, some market players in financial market suggested few ideas to be well thought-out by financial market authority in order to prevent the next instability. They suggested hiking the capital requirement to entry mutual fund market as well as strict qualification requirement for fund managers, strengthening law enforcement, including on adherence to guideline for representation of the product to investors. Additionally, fund managers should be able to anticipate the liquidity problem, especially for fixed income fund and money market fund, instead of continuing of selling the products.

V. Summary

Indonesian economy stood progressive improvement after the crisis (2003-mid 2005). The inflation was under control, exchange rate relatively stable and it caused central bank to lowering interest rate to further support economic growth. Economic growth in this period laid in 5% (y-o-y) on average explaining well-developed economic policy coordination between monetary and fiscal policy. Nevertheless, in mid 2005 particularly in 3rd quarter of 2005, the world oil price increased significantly that pushed the government to adjust domestic fuel price otherwise the domestic fuel subsidy would become very high. In this time, the domestic fuel price was adjusted 2 times (March 1st, and October 1st, 2006) with 29% in the 1st adjustment and 126% in the 2nd adjustment on average.

Right after the 2nd fuel price adjustment, the inflation went up from from only 9.06% (m-t-m) in September 2006 to 17.89% (m-t-m) in October 2006 followed by increased in inflation expectation. Because of that Bank Indonesia decided to increased the interest rate in order to lowering fuel price adjustment pressure to inflation and maintaining medium term inflation target on the track. But, unfortunately, this policy led to a panic selling (redemption) of bond (especially government bond) in mutual fund market. The investors redeemed their portfolio due to high return offered by other financial market mainly interest based investment portfolio as the central banks. The redemption itself made a negative total returns in the composite bond index, easing the price of government bond as well as dropping net asset value in mutual fund market up to Rp85.3 trillion from March to December 2005. Responding on this, some coordinated policy has been set by central bank to maintain macroeconomic stability and from Bapepam (as government regulator in bond market) to strengthen mutual fund market and bond market.

Finally, the turbulence gave a very good lesson to Indonesian economy. Firstly, mutual fund market as a new financial market should be more regulated and protected from potential risks. The regulation covers not only investment companies in mutual fund market but also their investors. The investors must be more objective in analyzing some investment alternatives and not only looking at the highest return promised by the investment managers. Secondly, the same extra regulations and attentions should also be given to bond market although its market is relatively smaller than other financial market. Lastly, as the domestic financial market is getting large, related each other and affected by external issues so it should also be realized that economic policy from government (regulators) would give an impact to all financial market. In order to keep stabilizing the economy, the policy impact must be well predicted and the financial market should be well prepared on that.

Appendix III.A : First and Second Fuel Price Adjustments

Table III.A.1
Domestic Fuel Price Adjustment

	Motor Gasoline			
	Pertamax Plus	**Pertamax**	**Petroleum**	
	Retail Price	Retail Price	Retail Price	Industrial Price
Mar.05	4200	4000	2400	2870
Oct.05	5900	5700	4500	5160
Feb.05	4200	4000	1810	2100

Table III.A.2
Domestic Fuel Price Adjustment

	Pertamina Dex		**Kerosene**		**Automotive Diesel Oil**		**Industrial Diesel Oil**		**Marine Fuel Oil**
	Retail Price	Industrial Price	Retail Price	Industrial Price	Retail Price	Industrial Price	Retail Price	Industrial Price	Retail Price
Feb.05	1800	2200	1650	2100	1650	2050	1560	1600	
Mar.05	2200	2790	2100	2700	2300	2660	2300	2300	
Oct.05	2000	5600	4300	5350	5130		3150		6300

Domestic fuel price has 2 types: (1) retail fuel price, price for retail customers like household, motor vehicle, etc and (2) industrial price, price for any kinds of industry. In terms of fuel products, Pertamina produces 6 products namely, motor gasoline, kerosene, automotive diesel oil, industrial diesel oil, marine fuel oil and pertamina dex. Among those products, the most important one which influence people's welfare and economics activities are motor gasoline and kerosene. Motor gasoline affects transportation cost, household cost and finally cost of products while kerosene influences deeply on household cost and business activities of many small-medium enterprises.

In the first hike (March 1st, 2005), all of fuel products except Pertamax Plus and Pertamax was adjusted 29% up on average. Compared with February 2005, the highest adjustment was charged to marine fuel oil (47.4% for retail price and 43.75% for industrial price) and the lowest adjustment was to kerosene with 22.2% up in retail price and 26.8% up in industrial price. But in the second one, all fuel products (no exception) rose 126% on average. Compared with March 2005, the significant price hike with big impact to economy was 87.5% up of retail price and 79.8% up in industrial price of Petroleum and 100.7% up in industrial price of kerosene.

Appendix III.B

Government Compensation Programs

Regarding the big impact from the October 1st oil price adjustment, the government compensated the impact ultimately to keep surviving the needy by providing cross subsidy under 4 programs:

1) Direct cash subsidy (BLT) to more than 60 million poor people (15.5 million families) or 28% of total population. Regarding BLT, a - Rp4.7 trillion had been allocated during October 1st, 2005 to December 31st, 2005 and for 2006 it will cost around Rp18.6 trillion.
2) Scholarship for education.
3) Improving health facilities, and
4) Developing infrastructure in suburb areas.

In total, DPR (House of Representative) and government has agreed to allocate Rp12.49 trillion for BBM's compensation which focusing mainly for education, health and infrastructure besides BLT. Particularly, there would be free tuition from elementary schools up to junior high schools. Under this scheme no discrimination whether poor people or rich people, all of Indonesian citizen at the age of 7-15 years old can go to school under country's responsibility for tuition and all other cost. Moreover, government has also been ruling free medical cost in public health center (Puskesmas) and state hospitals for poor people.

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