New twists and turns for Indonesia rupiah trading

Stricter regulation introduced by the central bank may have hurt liquidity but has also created opportunities in Indonesia, says Rebecca Patterson of JPMorgan.

Since Indonesia's central bank imposed stricter currency trading regulations on 15 January, investors managing rupiah (IDR) exposures have awoken to some serious new challenges – but also some opportunities. Not heard of IDFs? Well then, read on.

Bank Indonesia's regulations, first announced in mid-January and finally clarified on 31 January, are aimed at reducing volatility and ending what the central bank describes as 'speculative trade'. They effectively ban onshore banks from enacting certain transactions with non-residents (including foreigners and foreign institutions) and reduce the limit of forward FX transactions without any underlying investment purpose between onshore and offshore banks to $3m, from $5m previously (see *Table 1* for regulation details). Following the news, offshore parties were given until 7 February to settle any outstanding transactions.

Over the past month, initial fears over closing out positions and potential further restrictions have faded (the latter in part as Bank Indonesia officials have repeatedly assured market players that capital controls are not being considered). Instead, investors' and FX traders' attention has turned to dealing with the IDR's new world order. For treasurers, that world can be divided into two distinct parts: onshore trade and non-deliverable forwards (NDFs).

Both provide vehicles through which investors can manage IDR exposures. However, each has its own set of advantages, as well as limitations.

Trading onshore: credit, market development are key to success

Bank Indonesia and resident banks (including approved foreign banks onshore) are moving quickly to provide investors which previously hedged offshore more IDR trading options onshore. While it is still early days, December M2 money supply growth (M2 net foreign assets was up 5% m/m) suggests investors are bringing some money back onshore. The key developments to watch here will be January and February data to see if the trend continues after the regulations' implementation. Further, working with brokers, banks have created several pages to give indicative onshore FX and interest rate prices (see *Table 1*).

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Rebecca Patterson

Despite the banks' efforts, a number of challenges remain for onshore players. The main issue, at least for now, is credit. Especially for the foreign resident banks in Jakarta, appetite to trade with locally based firms and subsidiaries is still not high, particularly with the escalating economic and political uncertainties beleaguering Indonesia.

Another, albeit smaller, challenge is the limited range of products and liquidity available onshore. Traditionally, the lack of both led to even some local firms to look offshore, especially when managing longer-dated currency positions. Anecdotal evidence suggests such firms are willing to look onshore again for those medium-term trading needs – what will be important to watch in the coming months is how local banks respond. Establishing indicative price pages is a step in the right direction, but it remains far from a transparent market.

Staying offshore with non-deliverable forwards

While Bank Indonesia would prefer all business moving onshore, officials have repeatedly said that they cannot and will not do anything to prevent the development of offshore non-deliverable forward trading. This freshly created market, which officially kicked off on 19 February, has been dubbed 'IDFs' – short for IDR NDFs. Interest in IDFs has emerged quickly, mainly from companies but also from a few more speculative-type names.

That said, deal sizes suggest that both types of investors remain more curious about the market than they are willing to jump in with both feet. Trade sizes in late February were averaging between

TABLE 1

Onshore IDR rates (on Reuters)

Page name	Content description
PYIDR	Deliverable IDR currency and interest rate swaps from Prebon Yamane; one- to 10-year
EXCOJL	Onshore IDR cross-currency swaps from PT Exco Nusantara Indonesia; one to 10 years; also secondary IDR fixed income instruments
IDRFIX	IDR interest fixing rates from eight foreign banks with consensus figures; tom-next (next trading day) through one-year rates

Bank Indonesia regulation highlights (*visit www.bi.go.id/ for further details*)

1. Bank Indonesia prohibits banks from extending loans and other sources of rupiah funding to non-residents, including:
   a. Placement of IDR in the form of deposit or other means to offshore banks;
   b. Investment in IDR-denominated assets issued by non-residents;
   c. Inter-office transactions of IDR (domestic branch lends to offshore branches);
   d. Equity participation in IDR to non-residents; and
   e. IDR and foreign currency intraday overdrafts to non-residents.
2. BI also prohibits banks from transferring rupiah to non-resident accounts without underlying economic activities in Indonesia.

FIGURE 1

$1m and $5m, with about $50m in average daily turnover (for spot and IDFs). Bid/offer spreads have hovered around 50 rupiah for an average trade (about $2m in tenors up to three months).

To put IDFs in perspective, consider emerging Asia's most liquid NDF market: Korea. Average deal sizes in Korean won NDFs vary a lot more and are usually much larger – currently between $5m and $50m, while average daily turnover is roughly $2bn. However, evidence of investors looking at IDF trades in excess of $10m make FX traders hopeful that IDF business will continue to develop quickly, although the gap with Korean NDFs may take some time to narrow.

So trading size is an issue for IDFs. Perhaps the other, less concrete obstacle for IDFs is political support. There is very little interest by Bank Indonesia to promote the market – indeed, the IDF fixing page was created by a consortium of Singapore-based banks (the daily fixing is at 11am Singapore time on Telerate 50157, with more detail on 50177/78). Some investors have voiced concerns that Indonesia could go even further, pressuring banks and monetary authorities in Singapore to withdraw their support for IDFs. Those fears were fuelled in late February, when one Jakarta-based newspaper quoted a Bank Indonesia official as saying that the Monetary Authority of Singapore (MAS) had agreed not to approve trading in rupiah NDFs by Singapore-based banks.

The MAS denied making such an agreement and quickly highlighted that it neither controls nor prohibits foreign exchange activities such as NDF trading. However, jitters remain.

Where now for the rupiah?

Whether investors need to deal on- or offshore, they should be positioning for a weaker rupiah in the months ahead. Indeed, we believe four factors will drag the rupiah down as far as 12,000 by end-June against the dollar:

- rising worries that the government and President Wahid in particular are not able to stem social unrest and revive the economy;
- related worries that lack of reform progress will lead toward further delays of needed international loans;
- a lack of FX liquidity (hence relatively smaller flows pushing the spot rate further); and
- relatively long IDR positions in the market (implied by consensus forecast deviations from forwards).

While positions, central bank action and some IMF progress could bring near-term help for IDR, it seems unlikely to turn the currency's weakening trend for very long. Pressure on the government is set to keep rising in the coming months. The parliament threatened earlier this year to impeach President Wahid over two corruption scandals; many lawmakers have also openly criticized him for his leadership style and recently, what is seen as his failure to stem fighting in Borneo. The next "examination" of Wahid is expected early this summer. We would argue that even if Wahid were replaced by Vice President Megawati, it would do little right away to solve the country's ills. As is the case in Japan, they are beyond one person to solve. Any positive IDR reaction would likely prove short-lived.

With the political outlook dim, the economy slowing (we see 2001 GDP rising by 4% versus 5.2% last year), and the central bank's ammunition somewhat limited, any substantial move by local investors to change their money into dollars could easily push USD/IDR higher from current levels. ■

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