

CHAPTER I

INTRODUCTION

1.1 Background

Capital market indices hold a strategic role in a country's economy, serving not only as indicators of stock market performance but also as a reflection of investor confidence in economic stability and growth prospects. As an instrument that aggregates the value of a collection of traded stocks, the movement of an index reflects the market's collective expectations regarding corporate fundamentals, government policy, and global economic dynamics that also influence cross-border capital flows. For developing countries such as Indonesia, capital market indices whether domestically oriented, such as the Composite Stock Price Index (IHSG), or internationally oriented, such as Morgan Stanley Capital International (MSCI) function as a bridge connecting the domestic economy with the global financial system, while also serving as the primary benchmark investors use in making asset allocation decisions.

The existence of a credible and liquid capital market index is one of the main attractions for investors, both domestic and foreign. For domestic investors, capital market indices provide a transparent reference for measuring portfolio performance and comparing investment returns against the broader market. Meanwhile, for global investors particularly institutional investors such as pension funds, mutual funds, and sovereign wealth funds indices such as the MSCI Indonesia Index function as a standard benchmark that determines the direction of their capital allocation to emerging

markets. The inclusion of a stock in the MSCI index composition, for instance, directly influences the magnitude of incoming foreign capital flows as a result of passive investment strategies that track the index composition (index-tracking funds). Consequently, the movement and stability of a capital market index reflect not only domestic conditions but also determine the degree of confidence and interest that global investors hold toward a country's capital market.

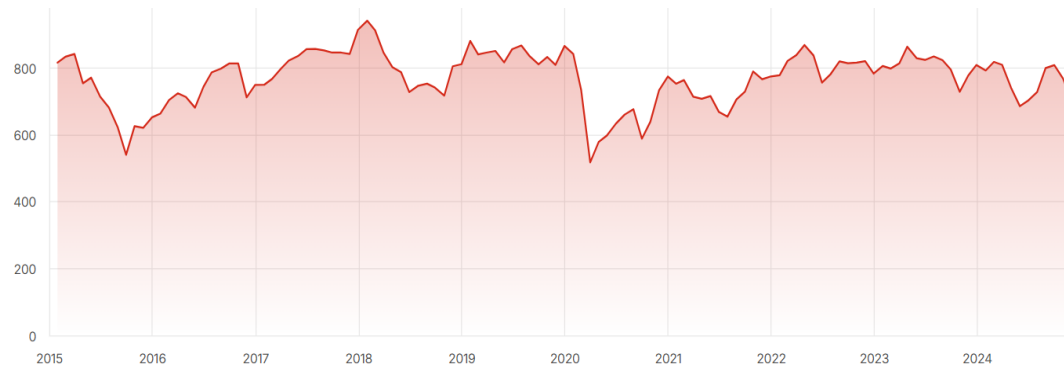
The attractiveness of a capital market index to global investors is heavily influenced by the dynamics of external variables beyond the control of domestic authorities. The monetary policy of advanced economies, particularly the benchmark interest rate policy of the U.S. central bank (the Federal Funds Rate), exerts a significant influence on the direction of global capital flows. When this benchmark rate rises, dollar-denominated investment instruments become relatively more attractive than risky assets in emerging markets, prompting capital outflows from domestic capital markets. In addition, the level of global market volatility, as reflected in the CBOE Volatility Index (VIX), serves as a risk sentiment indicator that influences global investor decisions.

A spike in the volatility index, reflecting heightened global market uncertainty, generally triggers risk-off behavior, in which investors withdraw funds from risky assets in emerging markets and reallocate them to assets considered safer (safe havens). The exchange rate of the domestic currency against the U.S. dollar is also a crucial external variable, as a weakening domestic currency can reduce the real value of investment returns for foreign investors, thereby diminishing the attractiveness of the domestic capital market in the eyes of global investors.

The Indonesian capital market serves as a vital component of the financial system, channeling medium- and long-term capital. Long-term public funds are channeled into productive sectors through the issuance and trading of securities such as stocks, bonds, and mutual funds on the Indonesia Stock Exchange (IDX). Institutionally, regulation and supervision are managed by the Financial Services Authority (OJK), while trading activities are facilitated by the IDX alongside supporting entities such as securities firms.

The Indonesian Central Securities Depository (KSEI), and clearing institutions, forming an ecosystem that promotes transparency, investor protection, and transaction efficiency. In recent years, the Indonesian capital market has shown rapid growth, marked by increasing retail investor participation, a wider range of investment products, and an expanding role in financing corporations and infrastructure projects, thereby strengthening its contribution to national economic growth. Recent academic studies confirm that the integration of the Indonesian stock market with global markets, alongside the strengthening of domestic factors such as macroeconomic fundamentals and local investor dynamics, are the primary drivers of stock index movements and the market's attractiveness to foreign investors (Sasono et al., 2025)

Figure 1. 1 Price performance in USD MSCI Indonesia (2015-2024)



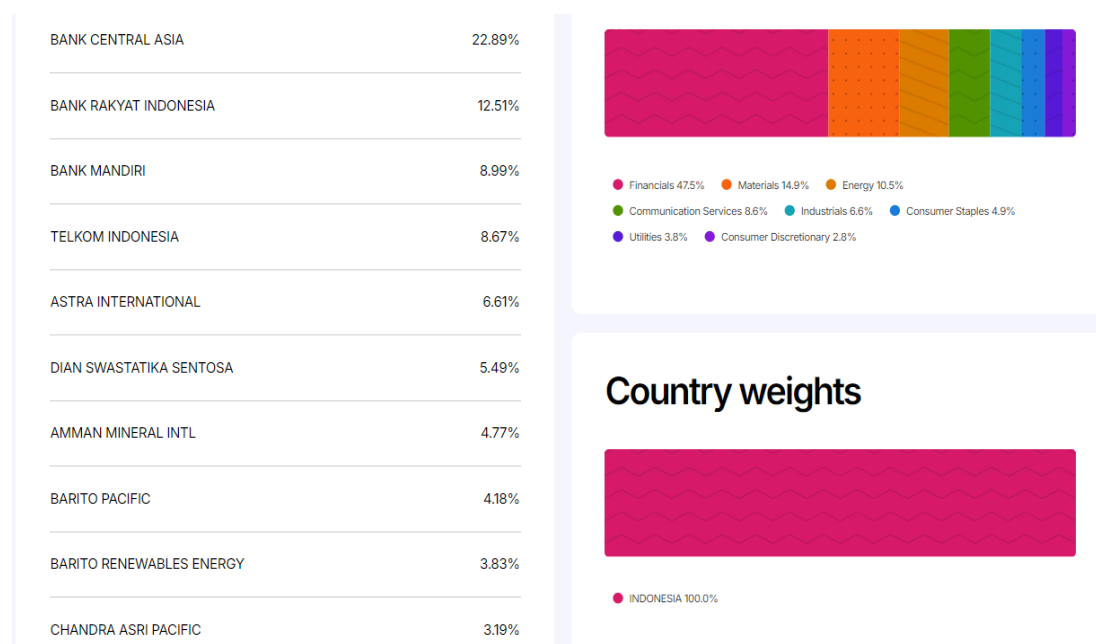
Source: MSCI (2025)

The Composite Stock Price Index (IHSG) is the principal indicator reflecting the overall performance of Indonesia's capital market, encompassing nearly all stocks listed on the IDX. As a market "barometer," IHSG movements capture the collective response of market participants to issuer fundamentals, government policy, monetary authority actions, and global dynamics, serving as an important benchmark for both domestic and foreign investors assessing the prospects of the Indonesian capital market.

IHSG is influenced not only by global factors such as world stock indices and international interest rates, but also by domestic sensitivities such as economic growth, inflation, and local investor behavior, making it a concrete representation of the capital market's role in financing and investment. Both IHSG and the MSCI Indonesia Index depict the performance of the Indonesian stock market from complementary perspectives: IHSG covers nearly all stocks listed on the IDX and acts as the primary barometer for domestic participants, whereas MSCI Indonesia is compiled by Morgan

Stanley Capital International using a global methodology. MSCI Indonesia focuses on large-cap and liquid stocks suited as a benchmark for international institutional investors. With many of IHSG's key constituents also included in MSCI Indonesia, their movements are typically aligned, although MSCI Indonesia more strongly reflects global investor sentiment and capital flows, while IHSG is more closely aligned with domestic investor dynamics and local market structure.

Figure 1. 2 Composition of MSCI Indonesia sectors



Source: MSCI (2025)

From the perspective of the Indonesian capital market, the interaction between IHSG and MSCI Indonesia illustrates financial integration: the strengthening of domestic fundamentals (stable economic growth, solid issuer performance, credible macro policy) strengthens IHSG while simultaneously increasing the attractiveness of MSCI Indonesia to global funds allocating cross-sector frontier portfolios. Recent

studies have found that global indices such as MSCI play an important role in directing foreign capital inflows into the Indonesian stock market; an increase in MSCI Indonesia's weighting or performance typically boosts foreign inflows, which in turn strengthens IHSG through the rising prices of its key constituents. Thus, IHSG reflects the overall domestic market response, while MSCI Indonesia functions as a "bridge" connecting the Indonesian capital market with global portfolios, together providing a more complete picture of the market's position and its attractiveness to both local and international investors (Arroisi & Koesrindartoto, 2019).

One of the external factors that exerts a significant influence on capital markets across various countries, including Indonesia, is the benchmark interest rate policy of the United States, known as the Federal Funds Rate (FFR). This rate is set by the Federal Open Market Committee (FOMC), the monetary policy committee under the United States central bank (the Federal Reserve), and serves as the benchmark overnight interbank lending rate in the U.S. money market. As the country with the world's largest economy and with the U.S. dollar functioning as the primary global reserve currency, any change in the Fed's interest rate policy carries effects that extend far beyond its domestic borders, influencing the direction of capital flows, exchange rates, and asset prices in nearly every country, including emerging economies such as Indonesia.

Throughout the period from 2015 to 2024, the Fed's interest rate policy went through several distinctly different phases. Between 2015 and 2018, the Fed began gradually normalizing its benchmark rate after having held it near zero percent in the aftermath of the 2008 global financial crisis, in response to improving domestic U.S.