



The Integration of Indonesia's Capital Market with the Global Economy: Opportunities, Challenges, and Policy Strategies

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Abstract. This study analyzes the degree of integration between Indonesia's capital market and global financial markets in the post-COVID-19 era of economic openness. Using a quantitative approach with panel data from 2015 to 2024, the research identifies correlation patterns between the Jakarta Composite Index (JCI) and major global stock market indices, including the S&P 500, MSCI Emerging Markets, and Nikkei 225. Findings reveal that the correlation between JCI and global indices increased significantly post-2020, reaching an average of 0.68 compared to 0.41 in the preceding period. The study also identifies three primary opportunities arising from this integration: enhanced market liquidity, diversification of the investor base, and broader access to foreign capital. Conversely, four critical challenges are identified: short-term capital flow volatility, rupiah exchange rate vulnerability, dependence on global sentiment, and regulatory gaps relative to international standards. Based on this analysis, five policy strategies are formulated, encompassing the strengthening of macroprudential frameworks, development of hedging instruments, capital market infrastructure modernization, regulatory harmonization with IOSCO standards, and enhancement of domestic investor financial literacy. The implications are relevant for policymakers at OJK, Bank Indonesia, and capital market participants in formulating strategies to navigate global financial market dynamics.

Keywords: Capital Market Integration; Financial Policy; Foreign Capital Flows; Global Market Correlation; JCI.

1. INTRODUCTION

The capital market is one of the fundamental components in a country's financial architecture. For Indonesia as the largest economy in Southeast Asia, the Indonesia Stock Exchange (IDX) plays a strategic role not only as a vehicle for domestic capital gathering, but also as an entry point for foreign portfolio investment. In the last two decades, financial liberalization accelerated by information technology developments has transformed Indonesia's capital market into an entity that is increasingly integrated with the global financial ecosystem (Agung et al., 2022; World Bank, 2023).

This integration dynamic creates a complex dualism of impact. On the one hand, openness to global capital flows brings opportunities in the form of increased liquidity, reduced capital costs, and the transfer of financial knowledge from international institutional investors. On the other hand, deeper integration also increases the vulnerability of the domestic market to external shocks such as the 2008 subprime mortgage crisis, the 2013 tapering tantrum, and the volatility triggered by the COVID-19 pandemic in 2020 (Hartono & Suryadi, 2021).

This phenomenon is increasingly relevant considering the structural changes that occurred post-pandemic. Over the past five years (2020–2024), the Indonesian capital market has recorded significant and challenging developments. JCI, which had been corrected to a level of 5,979 at the end of 2020 due to the shock of the COVID-19 pandemic, managed to

recover consistently: strengthening to 6,581 at the end of 2021 (+10.08% YoY), to 6,851 at the end of 2022 (+4.09% YoY), to 7,273 at the end of 2023 (+6.16% YoY), and closing at 7,080 at the end of 2024 and even touched an all-time high of 7,905 in September 2024 (IDX, 2024; OJK, 2024). The IDX's market capitalization also increased rapidly from IDR 6,970 trillion in 2020 to IDR 12,367 trillion at the end of 2024, while the number of capital market investors (Single Investor Identification / SID) grew almost fourfold from 3.88 million in 2020 to 14.87 million in 2024 (KSEI, 2024). On the foreign ownership side, the portion of foreign investors in C-BEST has consistently been in the range of 41–43% throughout the 2021–2024 period, indicating a significant dependence on global institutional investor sentiment. The development of these four main indicators is presented in the following Figure 1.



Figure 1. Trends in Key Indicators of the Indonesian Capital Market (2020–2024).

Source: IDX, KSEI, OJK (2024); compiled by the author.

The study of capital market integration has grown rapidly in the international financial literature. Several previous studies, including Engle & Granger (1987) which introduced the concept of cointegration, as well as the subsequent development by Bekaert & Harvey (1995) on segmentation and integration of emerging markets, have provided a strong methodological foundation. However, research that specifically examines the integration of Indonesia's capital market with a comprehensive policy dimension, especially in the post-pandemic context, is still limited.

This study aims to: (1) measure the level of integration of the Indonesian capital market with the global financial market using the latest data from 2015-2024; (2) identify opportunities that can be optimized from these integrations; (3) mapping challenges and risks that need to be mitigated; and (4) formulate comprehensive policy strategies for regulators and market participants. Through an approach that combines empirical analysis with comparative policy

studies, this research is expected to make an academic and practical contribution to the development of the Indonesian capital market.

2. LITERATURE REVIEW

Capital Market Integration Theory

Capital market integration is theoretically defined as a condition in which the financial markets of different countries are interconnected in such a way that assets with an equivalent risk profile have an equivalent rate of return, regardless of their geographical location (Stulz, 1981). Within this theoretical framework, a fully integrated market would result in the pricing of assets based on global risk factors, rather than purely domestic risk factors.

Bekaert & Harvey (1995) developed a model that allows the measurement of the degree of integration of emerging markets, showing that most emerging markets are in conditions between full segmentation and full integration. This model was later developed further by Carrieri et al. (2007) who introduced a measure of integration that varies over time, reflecting the reality that integration is not a static process.

In the context of ASEAN, research by Sehgal et al. (2019) found that the capital market integration of ASEAN-5 member countries, including Indonesia, experienced a significant deepening after the implementation of the ASEAN Economic Community (AEC). This finding was confirmed by Nguyen & Elisabeta (2020) who used the DCC-GARCH model to analyze conditional correlations between ASEAN markets.

Determinants of Capital Market Integration

The literature identifies several key determinants of capital market integration. First, the liberalization of capital accounts that facilitates the free movement of cross-border investment flows. Second, the development of electronic commerce technology that shortens the distance between transactions between markets. Third, the harmonization of international accounting regulations and standards that increase the comparability of financial information (Edison et al., 2002).

The fourth factor is the convergence of macroeconomic policies, where countries that have more transparent and predictable monetary and fiscal policy frameworks tend to have more integrated markets (Agung et al., 2022). Fifth, the role of global institutional investors who allocate their portfolios based on international benchmark indices such as MSCI, thereby creating a mechanical linkage between the markets included in the index.

The Impact of Integration: Empirical Evidence

Empirical evidence on the impact of capital market integration paints a mixed picture. On the positive side, Henry (2000) shows that capital market liberalization results in an average reduction in equity costs by 240 basis points in developing countries. Bekaert et al. (2005) found that financial integration contributes to an increase in average economic growth of 1% per year in the long run.

However, the downside is also well documented. Calvo & Mendoza (2000) show that in an integrated market, imperfect information can trigger herding behavior from global investors, creating excessive volatility. More specific research on Indonesia by Hartono & Suryadi (2021) found that shocks from the US stock market have an effect of 23% on JCI volatility in the short term, while this influence weakens to 11% in the long term.

3. RESEARCH METHOD

Data and Samples

This study uses secondary data on daily frequencies for the period January 2015 to December 2024 (2,500 observations). The main variables include: (1) the Composite Stock Price Index (JCI) as a representation of the Indonesian capital market; (2) S&P 500 (US); (3) MSCI Emerging Markets Index; (4) Nikkei 225 (Japan); (5) FTSE 100 (UK); (6) Shanghai Composite Index (China); as well as control variables in the form of USD/IDR exchange rates, BI-Rate interest rates, and commodity prices (petroleum and coal).

Data was obtained from Bloomberg Terminal, CEIC Data, and the official databases of Bank Indonesia and OJK. To ensure temporal consistency, all data is converted to the WIB time zone and adjusted to the trading day of the Indonesian exchange, by replacing the missing values using the linear interpolation method.

Analysis Method

The analysis was carried out in three stages. The first stage uses Dickey-Fuller (ADF) and Phillips-Perron (PP) augmented stationarity tests to ascertain the time series properties of the data. The second stage applies the Dynamic Conditional Correlation GARCH (DCC-GARCH) model developed by Engle (2002) to measure dynamic correlations between markets that vary over time, with the following specifications:

$$Q_t = (1 - \alpha - \beta)\bar{Q} + \alpha(\varepsilon_{t-1} \varepsilon'_{t-1}) + \beta Q_{t-1} \dots\dots\dots(i)$$

where Q_t is a conditional correlation matrix, $\bar{Q}$ is an unconditional correlation matrix, α and β are the parameters that measure the effects of ARCH and GARCH, and ε_t is a standardized residual.

The third stage uses the Johansen Cointegration Test method to test the existence of long-term equilibrium relationships between markets, followed by the Vector Error Correction Model (VECM) to analyze the dynamics of short-term adjustments towards long-term equilibrium.

4. RESULTS AND DISCUSSION

Development of Indonesian Capital Market Integration

The results of the DCC-GARCH model estimate show a significant increase in the dynamic correlation between JCI and global indices during the observation period. Table 1 summarizes the average correlation between periods:

Table 1. Dynamic Correlation Between the IHSG and Global Market Indices (DCC-GARCH).

Index Pairs	2015-2019	2020-2022	2023-2024	Trend
IHSG – S&P 500	0.38	0.65	0.72	↑
IHSG – MSCI EM	0.51	0.74	0.79	↑
IHSG – Nikkei 225	0.33	0.58	0.64	↑
IHSG – FTSE 100	0.29	0.52	0.59	↑
IHSG – Shanghai CI	0.41	0.61	0.67	↑
Average	0.38	0.62	0.68	↑

Source: DCC-GARCH Estimation Results, Compiled By The Author (2025).

These findings confirm the hypothesis of a significant increase in integration post-COVID-19 pandemic. The highest correlation is consistently found between JCI and the MSCI Emerging Markets Index (0.79 in 2023-2024), which can be explained by the fact that Indonesia is a component in the index, so that the allocation decisions of global fund managers' portfolios that use MSCI as a benchmark directly affect the movement of JCI.

Opportunities from Capital Market Integration

Based on data analysis and comparative policy studies, this study identifies three main opportunities that can be optimized from the integration of the Indonesian capital market with the global economy.

Opportunity 1: Increased Liquidity and Market Efficiency

Deeper integration brings a substantial increase in liquidity. IDX data (2024) shows that the average value of daily transactions has increased from IDR 8.3 trillion in 2015 to IDR 12.9 trillion in 2024. Higher liquidity not only facilitates investor entry and exit, but also contributes

to increased price discovery efficiency as measured by an average bid-ask spread reduction of 18% during the observation period.

Opportunity 2: Diversify the Investor Base and Lower Cost of Capital

The presence of foreign institutional investors with long-term investment horizons, such as sovereign wealth funds, pension funds, and global insurance, provides benefits in the form of stabilizing the investor base. The panel's regression analysis showed that a 1% increase in foreign ownership correlated with a decrease in equity costs by 7 basis points (significant at the 5% level), consistent with the findings of Henry (2000) and Bekaert et al. (2005) in other emerging market contexts.

Opportunity 3: Knowledge Transfer and Development of Financial Instruments

Integration drives the adoption of international best practice standards in corporate governance, financial reporting, and risk management. The IDX has successfully developed derivative instruments such as KBIE (Securities Index Futures Contracts) and IDX LQ-45 Futures that are in line with global market practices, providing hedging options that were previously unavailable to domestic investors.

Integration Challenges and Risks

While significant opportunities were identified, integration also created four critical challenges that require proper policy handling.

Challenge 1: Volatility of Short-Term Capital Flows (Hot Money)

VECM analysis shows that shocks from the global market are transmitted to the JCI within 1-3 trading days, with the full impact realized in 5-7 days. Volatile short-term capital flows (hot money) create sudden pressure on exchange rates and market liquidity. Bank Indonesia data (2024) shows that the reversal of foreign capital flows (sudden stops) in episodes of global financial stress reached Rp 45-60 trillion in a short period of 2-4 weeks.

Challenge 2: Rupiah Exchange Rate Vulnerability

The correlation between rupiah depreciation and JCI decline was found to be -0.67 during the observation period, indicating a strong correlation between the stock market and the foreign exchange market. Foreign investors who face the double losses of falling stock prices as well as currency depreciation tend to exit simultaneously, creating a negative spiral that worsens both markets simultaneously.

Challenge 3: Reliance on Global Sentiment

The results of the variance decomposition from the VECM model show that in the short term (5-10 days), around 34% of JCI volatility can be explained by global external factors, including Fed policy turmoil, geopolitical conflicts, and global investor risk-off sentiment. This

dependence limits the effectiveness of domestic monetary policy in stabilizing financial markets.

Challenge 4: Regulatory Gap with International Standards

Although the OJK has made various regulatory updates, a comparative review with the IOSCO Principles for Securities Regulation (2023) identified gaps in several aspects, including retail investor protection, beneficial ownership disclosure, and algorithmic trading supervision. This gap can be a barrier to the entry of global institutional investors that require certain regulatory standards.

Policy Strategy

Based on empirical findings and challenge analysis, this study formulates five integrated policy strategies that can be implemented in the short-term (1-2 years) to long-term (5-10 years) time frame.

Strengthening the Macroprudential Framework

The Financial Services Authority and Bank Indonesia need to develop a macroprudential framework that is responsive to the dynamics of cross-border capital flows. Recommendations include: development of an integrated Early Warning System (EWS) to detect real-time capital flow pressures; the establishment of a corridor policy for the rupiah exchange rate that can be activated in conditions of extreme turmoil; and the establishment of a Capital Flow Monitoring Unit that operates across agencies between the OJK, Bank Indonesia, and the Ministry of Finance.

Development of Hedging Instruments

The deeper development of the derivatives market is a strategic priority to enable issuers and investors to manage exchange rate risk exposure and market risk more effectively. These strategies include: expansion of currency futures contracts; development of interest rate swaps in rupiah denominations; fiscal incentives for the adoption of hedging instruments by corporations; and cooperation with the Singapore Exchange (SGX) to cross-list Indonesian asset-based derivative products.

Market Infrastructure Modernization

Investment in trading technology infrastructure is the foundation of all other strategies. Recommended programs include: increasing the capacity and reliability of the IDX trading system towards a latency standard below 1 millisecond; implementation of the T+1 settlement system (from the current T+2) in accordance with global trends; development of a cloud-based trading platform to improve the accessibility of retail investors; and the application of an artificial intelligence-based trade surveillance system to detect market manipulation.

Harmonization of Regulations with International Standards

The regulatory harmonization agenda needs to be prioritized in the context of the ASEAN Capital Markets Forum (ACMF) and IOSCO. Concrete steps include: full adoption of IFRS reporting standards for all IDX issuers; the implementation of the ESG (Environmental, Social, Governance) disclosure framework that is in line with ISSB (International Sustainability Standards Board) standards; modernizing short selling regulations to create a more efficient price discovery mechanism; and strengthening the protection of retail investors through the reform of regulations on handling complaints and compensation.

Increasing Domestic Investor Literacy and Participation

Strengthening the domestic investor base is the most important buffer against the volatility of foreign capital flows. These strategies include: a structured financial literacy program that reaches 50 million new investors by 2030 (from 14.87 million investors as of 2024); development of investment products that are in accordance with the risk profile of retail investors; tax incentives on long-term investment gains in the domestic market; and the integration of investment education in the university curriculum.

5. CONCLUSION AND SUGGESTIONS

This research has empirically confirmed that the integration of the Indonesian capital market with the global economy has undergone a significant deepening, especially post-COVID-19 pandemic. The average correlation of JCI with global market indices increased from 0.38 in the 2015-2019 period to 0.68 in 2023-2024. This trend reflects structural changes in asset ownership, the adoption of trading technologies, and the orientation of global financial policy. From the opportunity dimension, integration brings real benefits in the form of increased liquidity, reduced cost of capital, and knowledge transfer from international financial practices. However, these benefits come with risks that cannot be ignored, especially short-term capital flow volatility, exchange rate vulnerability, and reliance on global sentiment that is beyond the control of domestic policy.

The five policy strategies formulated in this study, strengthening macroprudential, developing hedging, modernizing infrastructure, harmonizing regulations, and strengthening the domestic investor base are a complementary policy package and must be implemented simultaneously, not partially. The effectiveness of each strategy will depend heavily on cross-agency coordination and long-term commitment from stakeholders. The limitations of this study lie in the use of daily data that may not fully capture intraday dynamics, as well as the assumption of stationariness in the VECM model. Further research is recommended to explore

the influence of non-economic factors such as political stability and institutional quality on the degree of integration of the Indonesian capital market, as well as to use a machine learning approach to identify nonlinearity in the transmission of shocks between markets. Practically, the results of this study confirm that strengthening coordination between Bank Indonesia, OJK, and the Indonesia Stock Exchange is a crucial factor in maintaining the stability of the national capital market amid increasing global financial integration. Without strengthening policy coordination, the domestic capital market will be increasingly vulnerable to the transmission of external shocks and volatility of foreign capital flows.

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