Between two paths toward deflation

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Summary

- The Indonesian financial market ended 2023 on a strong note, bolstered by foreign capital inflows into the domestic equities market as the Fed looks set to cut its policy rate in 2024.
- Despite the clear pivot signal, the extent to which the Fed would lower the FFR remains debatable as the central bank based its projection on the soft landing assumption while the market continues to expect an economic slowdown that would necessitate deeper rate cuts.
- The still-uncertain path towards the Fed's 2% inflation target may continue to pose a threat to the Indonesian economy, as lower-than-expected rate cuts following a soft landing may spark foreign capital outflows while declining global demand would spell troubles for the real economy.

- Shifting interest rate expectations and various economic and political events dotted the macroeconomic landscapes throughout 2023. Fortunately, the recent global economic and financial trends toward the end of 2023 seem to be moving in Indonesia's favour. For instance, the conclusion of the Fed's policy tightening cycle significantly reduces the depreciation pressure on the domestic money market, allowing the Rupiah to maintain its 1.10% YTD gains despite the downturn throughout Q2-Q3 2023.
- While the guns fell silent in the domestic money market, the same thing may not be said about Indonesia's bond market. Although the benchmark yield on the SBN market might be trending downward to 6.45% by year-end, the observed USD 88.1 million foreign capital outflows in the final week of 2023 signal an increased role of domestic investors in driving demand within the SBN market. Despite the global bond market's end-of-year rally, the heightened bid-ask spread for 10Y SBN still reflects investors' persistent demand for a higher rate ***(see Chart 1).*** This aligns with reports of substantial fiscal disbursement in December 2024, fostering expectations of increased SBN issuance in the upcoming period.
- Meanwhile, the domestic equities market did not find problems in stealing the attention of foreign investors, drawing in USD 186.6 Mn of foreign capital inflows despite the shortened trading week. While the anticipation of a last hurrah in Indonesia's commodity sector ahead of the upcoming dividend cycle might entice some foreign investors into the Indonesian equities market, it is hard to explain foreign

investors' consistent net buy without considering the broader context of easing global rate expectations.

- The renewed vigour in the Indonesian market (and other risky markets) may not be possible without the now-clear signal about the direction in which the Fed would move its policy rate in 2024. While the question of how far the Fed would cut its policy rate remains debatable, Chairman Powell's assessment that it would be "too late" to cut the interest rate once inflation hits the 2% target did little to rein in the market's more aggressive pivot expectation. What it leads to, then, is the loosening of US financial conditions to a level not seen since early June 2022, a period before the Fed spooked the market by hiking the policy rate by 75 bps in a single meeting.

- Ultimately, whether the Fed would cut its policy rate three (75 bps, as indicated in FOMC's summary of economic projections) or six times (150 bps, as indicated by FFR futures) in 2024 would depend on what kind of deflationary events that we would run into in the New Year. On the one hand, the progress towards the 2% inflation target may continue to transpire through improvements in the supply conditions, as has happened since inflation hit its peak in Q2-2022. Owing to its statistical peculiarity, the shelter part of US CPI inflation may also continue to trend lower in 2024, leaving the wage-driven services component to fuel the CPI inflation number.

- Such a soft landing scenario may explain the Fed's more measured rate cuts signal in 2024. The sticky shelter inflation means that the headline CPI number would gradually move to the 2% inflation target in its own time, while the still-positive wage growth would help to balance the GDP growth amidst the ongoing deflation. On the Fed's side, then, the urgency to reduce the policy rate beyond the communicated 75bps appears to be minimal; thus allowing the central bank to further sweat out its excess reserves which, perhaps, would eventually move the central bank to revert back to the more conservative "corridor" system in formulating its monetary policy.

"While the Fed looks set to cut its policy rate in 2024, how far the Fed would lower the FFR remains debatable"

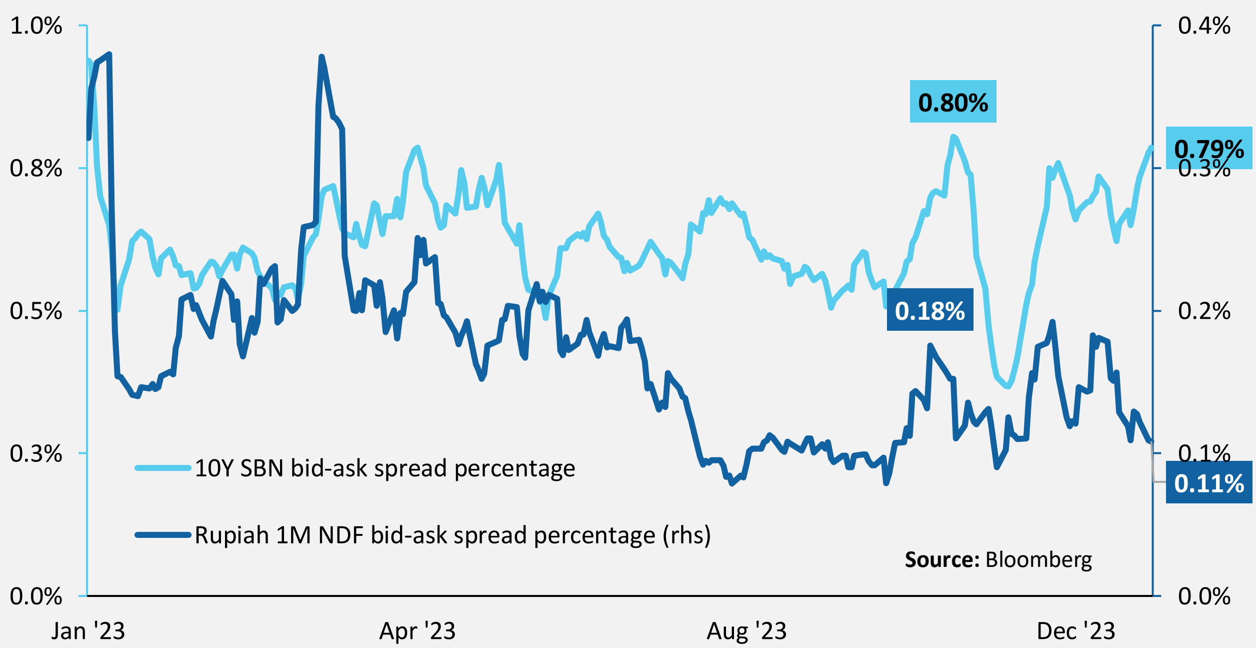
- Looking from the market's side, the pivot expectation seems to align more with a rather pessimistic outlook. The global oil market exemplifies this stance vividly. Despite numerous disruptions in global oil supply (such as recent attacks on the Red Sea, which now led to higher premiums on shipping) oil prices remained subdued in the closing days of 2023, pointing at depressed demand for oil or other energy commodities. Notwithstanding the recent intensification in the global push for reducing fossil fuel demand, the declining demand for energy commodities still plays a role in hinting at a potential economic slowdown. Consequently, this might increase the pressure on the Fed to significantly reduce the policy rate, aiming to guide the economy away from the anticipated recession.

- The market, then, seems to be reading Chairman Powell's dovish post-FOMC statement as a warning of an impending recession, rather than a sign of increasing optimism that the soft landing scenario has been secured in the Fed's bag. Indeed, some segments of the market seem to be leaning towards the recession-ist camp, as indicated by the increasing short positions relative to long positions reported in the futures market, especially for commodities such as oil ***(see Charts 2 & 3).***
- The Indonesian economy, then, remains susceptible to threats, irrespective of which deflationary outlook ultimately prevails. A future outcome closer to the Fed's projections might unsettle the market, potentially triggering capital outflows as investors reassess the liquidity condition and thus jeopardising the domestic financial market. Conversely, the downturn in the global aggregate demand, as anticipated by the market, would of course spell bad news for Indonesia's real sector. Given the anticipated role of fiscal spending in boosting the domestic aggregate demand (and thus, the economy) in H1 2024, it might be prudent for Bank Indonesia to continue focusing their resources on protecting the financial market from these external risks, especially given the still-subdued inflation risk in Indonesia.

Chart 1

Higher yields, please

The Indonesian bond market suffered from foreign capital outflows in the last week of 2023 as news of higher fiscal spending leads to investors demanding higher rates

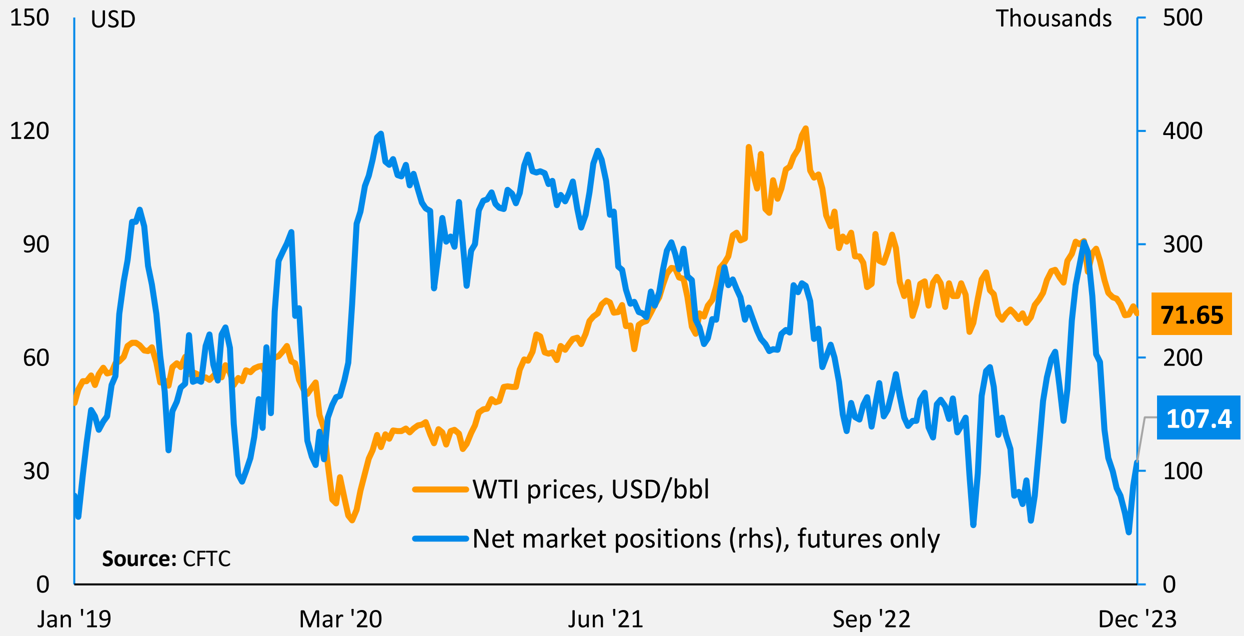


Source: Bloomberg

Chart 2

Chalk and Cheese (1)

Oil traders' increasingly pessimistic market positioning further contributes to the weakness in global oil prices and the expectation for an impending global economic slowdown...

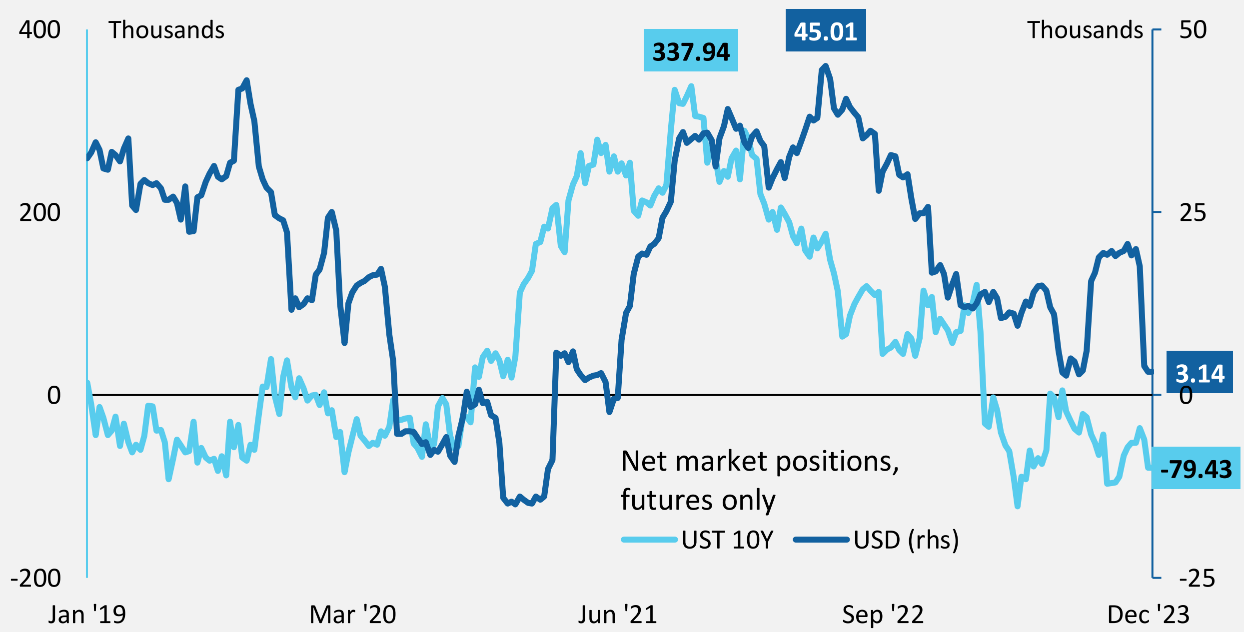


Source: CFTC

Chart 3

Chalk and Cheese (2)

...concurrently, the still-negative sentiment on the USD and the UST markets illustrates market uncertainty regarding the rate outlook



Source: CFTC

Economic Calendar

		Actual	Previous	Forecast*
2 January 2024				
ID	S&P Global Manufacturing PMI	52.2	51.7	51.9
CN	Caixin Manufacturing PMI	50.8	50.7	50.7
ID	**Inflation rate YoY**	**2.61%**	**2.86%**	**2.6%**
3 January 2024				
US	JOLTs Job Openings (USD Mn)		8.73	8.75
US	ISM Manufacturing PMI		46.7	47.3
5 January 2024				
US	Non-Farm Payroll (‘000)		199	150
8 January 2024				
ID	**Foreign Exchange Reserves (USD Bn)**		**3.17**	**3.18**
9 January 2024				
ID	Consumer Confidence		123.6	-
US	Balance of Trade (USD Bn)		-64.3	-64.8
10 January 2024				
ID	Retail Sales YoY		2.4%	-
11 January 2024				
US	Inflation Rate YoY		3.1%	3.0%
ID	Motorbike Sales YoY		-2.8%	-
12 January 2024				
CN	Inflation Rate YoY		-0.5	-0.7
13 January 2024				
CN	Balance of Trade (USD Bn)		68.3	46
15 January 2024				
EU	Balance of Trade (EUR Bn)		11.1	-
ID	**Balance of Trade (USD Bn)**		**2.41**	**5**
16 January 2024				
ID	**Interest Rate Decision**		**6%**	**-**
19 January 2024				
ID	Loan Growth YoY		9.74%	-
24 January 2024				
ID	**Foreign Direct Investment YoY**		**-**	**-**

*Forecasts of some indicators are simply based on market consensus
Bold indicates indicators covered by the BCA Monthly Economic Briefing report

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	5.50	Dec-23	2.40
UK	5.25	Dec-23	1.35
EU	4.50	Dec-23	2.10
Japan	-0.10	Jan-16	-2.90
China (lending)	2.50	Dec-23	4.85
Korea	3.50	Nov-23	0.30
India	6.50	Dec-23	0.95
Indonesia	6.00	Nov-23	3.39
Money Mkt Rates	**29-Dec**	**-1 mth**	**Chg (bps)**
SPN (1M)	5.88	5.80	7.6
SUN (10Y)	6.45	6.67	-21.8
INDONIA (O/N, Rp)	5.88	5.92	-3.8
JIBOR 1M (Rp)	6.65	6.65	-0.5
Bank Rates (Rp)	**Oct**	**Sep**	**Chg (bps)**
Lending (WC)	9.05	9.02	2.79
Deposit 1M	4.43	4.33	10.10
Savings	0.67	0.66	0.19
Currency/USD	**29-Dec**	**-1 mth**	**Chg (%)**
UK Pound	0.785	0.788	0.29
Euro	0.906	0.910	0.42
Japanese Yen	141.0	147.5	4.57
Chinese RMB	7.100	7.136	0.51
Indonesia Rupiah	15,397	15,435	0.25
Capital Mkt	**29-Dec**	**-1 mth**	**Chg (%)**
JCI	7,272.8	7,041.1	3.29
DJIA	37,689.5	35,417.0	6.42
FTSE	7,733.2	7,455.2	3.73
Nikkei 225	33,464.2	33,408.4	0.17
Hang Seng	17,047.4	17,354.1	-1.77
Foreign portfolio ownership (Rp Tn)	**Nov**	**Oct**	**Chg (Rp Tn)**
Stock	3,136.1	2,895.1	240.91
Govt. Bond	833.9	810.4	23.50
Corp. Bond	11.2	11.3	-0.14

Trade & Commodities	29-Dec	-1 mth	Chg (%)
Baltic Dry Index	2,094.0	2,391.0	-12.4
S&P GSCI Index	535.6	558.5	-4.1
Oil (Brent, $/brl)	77.0	81.7	-5.7
Coal ($/MT)	133.8	129.2	3.6
Gas ($/MMBtu)	2.58	2.80	-8.0
Gold ($/oz.)	2,063.0	2,041.0	1.1
Copper ($/MT)	8,463.9	8,387.8	0.9
Nickel ($/MT)	16,375.0	16,539.0	-1.0
CPO ($/MT)	802.7	802.9	-0.0
Rubber ($/kg)	1.53	1.46	4.8
External Sector	**Nov**	**Oct**	**Chg (%)**
Export ($ bn)	22.00	22.15	-0.67
Import ($ bn)	19.59	18.67	4.89
Trade bal. ($ bn)	2.41	3.47	-30.56
Central bank reserves ($ bn)*	138.1	133.1	3.73
Prompt Indicators	**Nov**	**Oct**	**Sep**
Consumer confidence index (CCI)	123.6	124.3	121.7
Car sales (%YoY)	-7.5	-13.8	-20.1
Motorcycle sales (%YoY)	-2.8	-4.0	-0.9
Manufacturing PMI	**Nov**	**Oct**	**Chg (bps)**
USA	46.7	46.7	0
Eurozone	44.2	43.1	110
Japan	48.3	48.7	-40
China	50.7	49.5	120
Korea	50.0	49.8	20
Indonesia	51.7	51.5	20

Source: Bloomberg, BI, BPS
Notes:
^Data for January 2022
*Data from an earlier period
For changes in currency: **Black indicates appreciation against USD, **Red** otherwise
***For PMI, **>50** indicates economic expansion, **<50** otherwise

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Indonesia – Economic Indicators Projection

	2019	2020	2021	2022	2023E	2024E
Gross Domestic Product (% YoY)	5.0	-2.1	3.7	5.3	5.1	5.0
GDP per Capita (US$)	4175	3912	4350	4784	4982	5149
Consumer Price Index Inflation (% YoY)	2.7	1.7	1.9	5.5	2.6*	3.2
BI 7-day Repo Rate (%)	5.00	3.75	3.50	5.50	6.00*	5.50
USD/IDR Exchange Rate (end of the year)**	13,866	14,050	14,262	15,568	15,397*	16.037
Trade Balance (US$ billion)	-3.2	21.7	35.3	54.5	34.9	32.6
Current Account Balance (% GDP)	-2.7	-0.4	0.3	1.0	-0.4	-0.5

*Actual Number

** Estimation of the Rupiah's fundamental exchange rate

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