

FOMC:

Shock, awe, friendly fire?

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Executive Summary

- The Fed raised the Fed Funds Rate by 75 bps, bringing it up to 1.50 – 1.75%.
 - Persistent uncertainties with regards to inflation due to the ongoing Russia-Ukraine war as well as China's zero-Covid policy, as well as resulting high inflation expectations, were the main drivers behind the Fed's decision.
 - At the same time however, a more aggressive tightening cycle risks triggering a recession in the US, as well as broader financial instability in the global economic periphery.
 - While relatively low inflation and a solid trade surplus have helped shelter Indonesia for the moment, longer term uncertainties regarding inflation and whether the Fed can successfully engineer a soft landing will weigh on BI's policy considerations.
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- A relative measure of calm had managed to settle over markets in the months of April and May, an armistice that allowed it to settle on a 50 bps rate hike consensus for June's FOMC. Alas, fate had other plans. A combination of a higher than expected inflation figure, as well as steadily rising inflation expectations, shook an already jittery market in the early weeks of June. Markets panicked, 50 became 75, and the Fed was swept along with the tide. And so it was that yesterday's FOMC meeting ended with a Fed Funds Rate (FFR) sitting at the 1.50 - 1.75 range, 75 bps higher than before.
 - The market's (and the Fed's) sudden turnaround highlights very real uncertainties regarding inflation, especially its long-term trajectory. The Russia-Ukraine war continues to drag on with a still uncertain path to its resolution, and futures prices show that markets expect oil prices to remain above 100 USD/bbl even a year from now, highlighting just how obscure future expectations remain under the thick fog of war. And while price indicators for certain components such as vehicles suggest that Covid-related supply disruptions may be easing (**Chart 1**), the spread of Omicron in China and its continued zero-Covid response threatens to disrupt this as well.
 - The fact that inflation expectations for the next three years are still hovering around 4% suggests that markets are cognizant that transitory inflation is no longer a likely scenario. Indeed, the Fed itself explicitly stated rising inflation expectations as one of the key drivers behind its decision to hike rates by 75 bps; as rising inflation expectations may drive workers to push for ever higher wages, potentially feeding into a wage-price spiral.

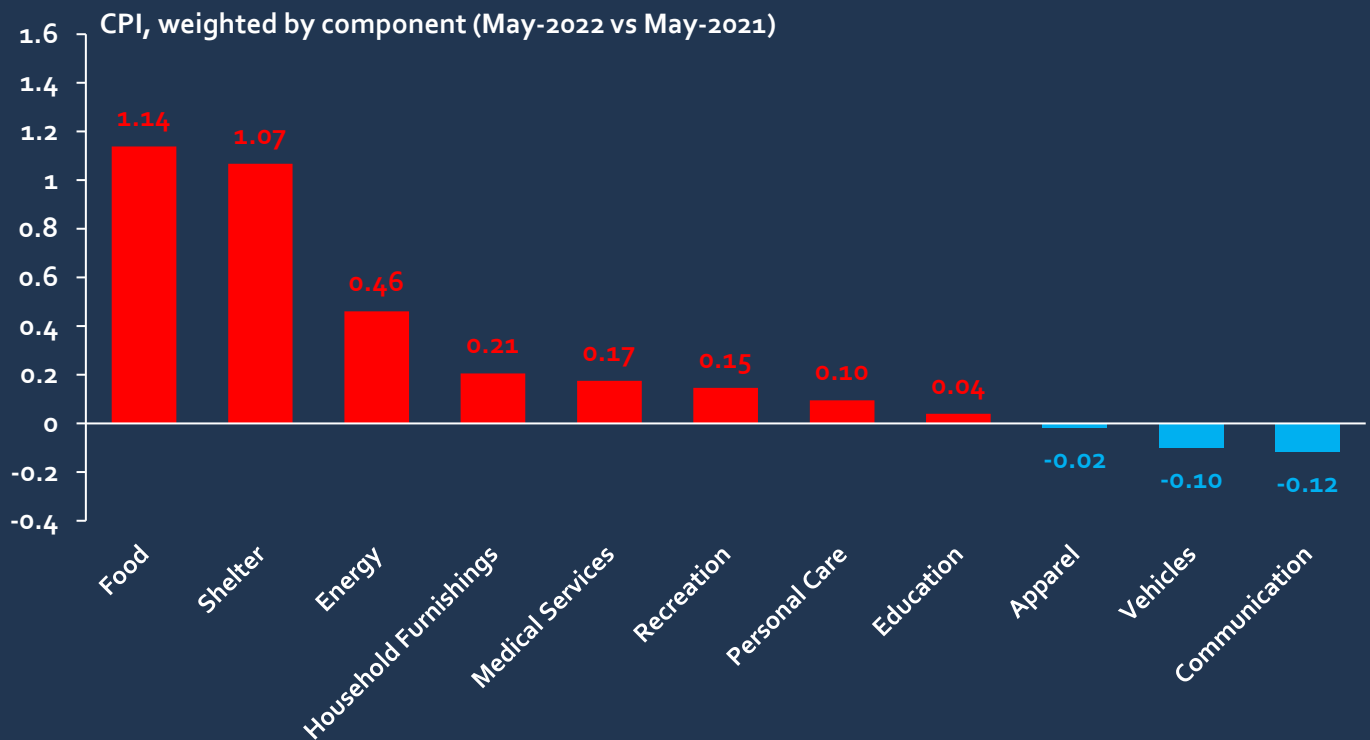
- Inflation then, is clearly a formidable opponent, one that justifies the heavy weaponry that the Fed seems to be bearing down upon it. The bigger the guns however, the greater the risks of collateral damage. This lies at the heart of the Fed's dilemma, and explains much of the market turmoil over the previous weeks: inflation requires heavy lifting, but is the cure more dangerous than the disease? It is important to note, for instance, that the Fed cannot fully control inflation. While rate hikes could have a significant effect on certain large drivers of inflation such as housing, a large portion of the current rise in prices is being driven by supply shocks in food and energy due to the Russia-Ukraine war (**Chart 1**).
- If much of this inflation is supply-driven, and there must be demand destruction to compensate, we must undoubtedly face the questions: how much destruction is necessary, and how much is the US willing to accept? The Fed's GDPNow indicator shows that even before the recent rate hike, current economic growth has already declined to close to 0%. More aggressive tightening could very well push these numbers down even lower. Timing will also prove to be tricky, and the Fed must be careful not to overshoot. Some have noted that overly rapid rate hikes could simply punch through property developers, drastically reducing housing construction and keeping prices high.
- Finally, aggressive monetary tightening by the Fed would also have significant effects on the rest of the global economy as well. Those on the global periphery would face the effects of tightening on two fronts: the direct effects of higher interest rates on the one hand, and a strengthening of the USD in proportion to decreasing dollar liquidity on the other. While these aftershocks will be felt everywhere, their effects will be greatest in emerging markets. Indeed, a comparison of bond performances indicates that the effects of tightening are already weighing more heavily on emerging markets relative to the developed world (**Chart 2**).
- These considerations then, may limit the Fed's ability to tighten monetary policy too aggressively. Attempting to achieve positive real rates in the US for instance (which would require the FFR to move up to 8%), would put significant strain on the debt servicing capacities of emerging markets, particularly those with higher proportions of external debt. Coupled with the inflationary pressures of rising food and oil prices, these pressures may prove to be quite destabilizing to emerging markets.
- While the Fed's mandate only requires it to train its eye on the US economy, ignoring developments in emerging markets still carries risks, even on these terms. Indeed, the financial contagion from stresses in emerging markets may eventually have adverse effects on the US economy itself, a point that is likely to have grown more pronounced when one considers the growing financial globalization of the past decade. Moving forward with aggressive tightening by the Fed then, may need to be accompanied with liquidity provisions to the global periphery such as FX swap/repo lines in order to contain the risks of financial destabilization. However, this is a contradictory policy combo and one that has to be pursued delicately – witness the ECB's difficult attempt to thread the needle between fighting inflation and narrowing Southern Europe's yield spread.
- Despite these risks however, Indonesia still remains slightly behind the monetary tightening curve relative to most of its emerging Asian peers. That it can afford to do this is due to several luxuries that it enjoys. First, as a commodity exporter, Indonesia is one of the few beneficiaries of the current surge in commodity prices (particularly for coal), and enjoys a strong trade surplus. Second, Indonesia boasts one of the lowest rates of inflation in

Southeast Asia, propped up partly by the government's ongoing energy subsidies, allowing it maintain a health real yield differential without raising rates.

- None of this however, means that Indonesia is bulletproof. Indeed, while risk perceptions of Indonesia, measured by its 5-year CDS, are still lower relative to its Latin American peers, they remain one of the highest in Southeast Asia. The Fed's own rate hike schedule, currently projected to put the FFR at the 3.25 – 3.50 range based on its own dot plot, would also eventually require higher rates from Bank Indonesia (BI) as well, even if inflation remains relatively under control.
- Lurking behind this more immediate accounting of strengths and vulnerabilities however, is another potential threat rooted in diverging medium-term expectations. The Fed, on the one hand, has tabled in no overly dovish pivot over the next three years in its dot plot. By admitting that drastic monetary easing will not be necessary, the Fed seems to be betting on its ability to engineer a soft landing. Indonesia's own expectations however, appear to be based on a different ballgame. Energy subsidies, which are to be extended for the year, are based on the assumption that oil prices remain at USD 100/bbl, with the hope that oil prices might perhaps normalize the following year. Such a drastic reduction in prices aligns more with a scenario where the Fed fails to prevent a hard landing, and the resulting recessionary shock cools prices down. Implicit to such a scenario as well of course, would be a dovish turn by the Fed in response to recession.
- The deep uncertainty with regards to inflation's long-term prospects has already been touched on above. This divergence in expectations however, also reveals equally persistent uncertainties with regards to the Fed's monetary trajectory as well, much of which centers on whether the Fed will be able to successfully engineer a soft landing or not. Despite the advantages that Indonesia enjoys at present then, uncertainties over longer-term developments are likely to press ever harder on BI's policy considerations, and Indonesia's reluctance to act pre-emptively may end up causing rapid (and painful) monetary and fiscal adjustment by next year. It is with this in mind that we maintain our call that BI would raise rates by 50-150 bps before the end of the year.

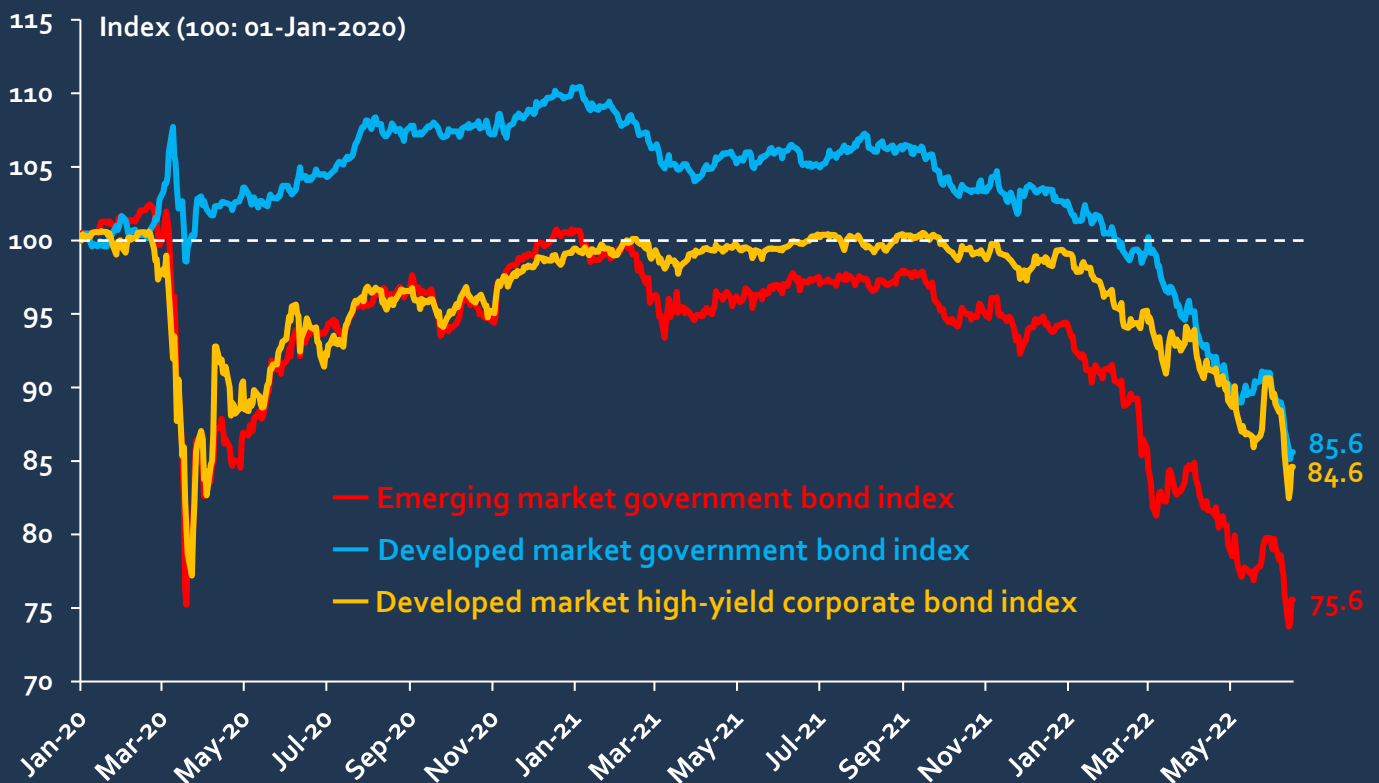
"While the aftershocks of Fed tightening will be felt everywhere, their effects will be greatest in emerging markets"

Chart 1. Aside from shelter, a significant portion of US inflation is being driven by supply shocks in food and energy



Source: US Bureau of Labor Statistics

Chart 2. Emerging market assets appear to have taken a greater hit from the Fed's tightening compared to developed countries, as seen from bond performance



Source: Bloomberg (last update: 16-Jun-2022)

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	15-Jun	-1 mth	Chg (%)
US	1.00	May-22	-7.60	Baltic Dry Index	2,387.0	3,104.0	-23.1
UK	1.00	May-22	-8.00	S&P GSCI Index	776.5	759.7	2.2
EU	0.00	Mar-16	-8.10	Oil (Brent, \$/brl)	118.5	111.6	6.2
Japan	-0.10	Jan-16	-2.60	Coal (\$/MT)	345.0	344.8	0.1
China (lending)	4.35	Oct-15	2.25	Gas (\$/MMBtu)	7.72	7.78	-0.8
Korea	1.75	May-22	-3.65	Gold (\$/oz.)	1,833.8	1,811.8	1.2
India	4.90	Jun-22	-2.14	Copper (\$/MT)	9,224.5	9,184.6	0.4
Indonesia	3.50	Feb-21	-0.05	Nickel (\$/MT)	25,759.0	27,171.5	-5.2
Money Mkt Rates	15-Jun	-1 mth	Chg (bps)	CPO (\$/MT)	1,341.8	1,570.6	-14.6
				Rubber (\$/kg)	1.60	1.57	1.9
SPN (1M)	3.21	3.64	-42.9	External Sector	May	Apr	Chg (%)
SUN (10Y)	7.40	7.36	3.9	Export (\$ bn)	21.51	27.32	-21.3
INDONIA (O/N, Rp)	2.79	2.79	-0.7	Import (\$ bn)	18.61	19.76	-5.8
JIBOR 1M (Rp)	3.54	3.54	0.1	Trade bal. (\$ bn)	2.90	7.56	
Bank Rates (Rp)	Feb	Jan	Chg (bps)	Central bank reserves (\$ bn)*	135.6	135.7	-0.04
Lending (WC)	8.62	8.66	-3.55	Prompt Indicators	May	Apr	Mar
Deposit 1M	2.85	2.88	-3.49	Consumer confidence index (CCI)	128.9	113.1	111.0
Savings	0.63	0.69	-6.27	Car sales (%YoY)	-9.8	5.0	16.0
Currency/USD	15-Jun	-1 mth	Chg (%)	Motorcycle sales (%YoY)	N/A	-7.1	-13.6
UK Pound	0.821	0.816	-0.67	Cement sales (%YoY)	N/A	-10.0	23.2
Euro	0.957	0.960	0.31	Manufacturing PMI	May	Apr	Chg (bps)
Japanese Yen	133.8	129.2	-3.45	USA	56.1	55.4	70
Chinese RMB	6.715	6.789	1.11	Eurozone	54.6	55.5	-90
Indonesia Rupiah	14,743	14,613	-0.88	Japan	53.3	53.5	-20
Capital Mkt	15-Jun	-1 mth	Chg (%)	China	48.1	46.0	210
JCI	7,007.1	6,598.0	6.20	Korea	51.8	52.1	-30
DJIA	30,668.5	32,196.7	-4.75	Indonesia	50.8	51.9	-110
FTSE	7,273.4	7,418.2	-1.95				
Nikkei 225	26,326.2	26,427.7	-0.38				
Hang Seng	21,308.2	19,898.8	7.08				
Foreign portfolio ownership (Rp Tn)	May	Apr	Chg (Rp Tn)				
Stock	2,503.9	2,599.7	-95.79				
Govt. Bond	795.7	827.9	-32.12				
Corp. Bond	18.1	18.5	-0.47				

Source: Bloomberg, BI, BPS

Notes:

*Data from earlier period

For changes in currency: **Black indicates appreciation against USD, **Red** otherwise

***For PMI, **>50** indicates economic expansion, **<50** otherwise

Indonesia – Economic Indicators Projection

	2017	2018	2019	2020	2021	2022E
Gross Domestic Product (% YoY)	5.1	5.2	5.0	-2.1	3.7	4.8
GDP per Capita (US\$)	3877	3927	4175	3912	4350	4615
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	4.2
BI 7 day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	4.0
USD/IDR Exchange Rate (end of year)**	13,433	14,390	13,866	14,050	14,262	14,660
Trade Balance (US\$ billion)	11.8	-8.5	-3.2	21.7	35.3	48.5
Current Account Balance (% GDP)	-1.6	-3.0	-2.7	-0.4	0.3	1.4

** Estimation of Rupiah's fundamental exchange rate

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