FOMC:
Same move, different spin

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Executive Summary

- The Federal Reserve raised the Fed Funds Rate by another 75 bps, bringing it up to 2.25 – 2.50%. The market, however, appears to react to the announcement in a positive light as the Fed chair Jerome Powell signals that the policy rate is now hovering closer to the 'neutral rate'.
- More rate hikes are still in the card as inflation is still miles off the 2% target. However, the Fed might be tempted to slow its tightening pace as inflation expectation is now trending downward and the economy inching closer to the negative growth zone.
- Beside early successes, higher FF rates, stronger USD, and normalizing commodity prices would make it hard for BI to maintain the IDR's value without increasing the BI 7DRR.

- The latest FOMC meeting changed… essentially not much from the previous one. The Fed threw another 75-bps hike, lifting the Fed funds rate between 2.25 – 2.50%, while quantitative tightening (QT) continues on its pre-set course. In spite of this, the markets' reaction to the meeting appeared optimistic, with equities rising and bond yields receding soon after. So what gives?

- The positive reaction appears to hinge on some subtle clues that the Fed *might just* pivot to a dovish stance sooner rather than later. The first is its acknowledgment, in its policy statement, that economic activity has softened – in contrast to the laser focus on inflation in June. The second is an apparently off-the-cuff statement by Jerome Powell that the Fed funds rate has approached a "neutral level," where inflation theoretically should stop accelerating and may begin to cool down.

- However, the recent spike in risk-on sentiment may prove to be short-lived. For one, Powell also stated that another "unusually large" hike might be appropriate, depending on the data. There is also no guarantee that the Fed would not hike beyond the neutral rate if inflation remains elevated. Perhaps a better reading of the Fed's statements is that it still sees inflation as its primary goal, and – while it would prefer not to – further hikes might be warranted even if it may cause a brief recession. Finally, Powell's belief that US GDP growth was still positive in Q2-22 (thus avoiding technical recession) implies that the Fed has at least one more quarter to assess whether further hikes into a recession would be justified or not.

- As such, Q3-22 (and the September meeting) will be the moment of truth for the Fed. The slew of negative data earlier this month, accompanied by bad news outside the US – energy crunch in Europe, mortgage concerns in China – makes the probability of negative growth this quarter much higher than the previous two (***Chart 1***). Both the financial and commodity market has positioned themselves for this, too, as seen from the falling commodity prices and normalising inflation expectations ***(Chart 2)***, and also from the fact that the market is betting on Fed rate cuts – not hikes – for 2023-24.

- The big question, then, is whether or not inflation will remain hot amid this putative recession – in particular, whether the recent fall in commodity prices will translate to a "quick win" that would allow Powell and co to declare "mission accomplished" and pivot. Without this "win", it remains possible that commodity-exporting emerging nations like Indonesia would suffer a double blow, from a stronger USD and lower commodity prices. Stronger USD, we should note, is historically correlated with weaker commodity prices, although this was not the case earlier this year as consternation due to the military war in Ukraine led to bidding wars in the commodity market.

"There is no guarantee that the Fed would not hike beyond the neutral rate if inflation remains elevated".

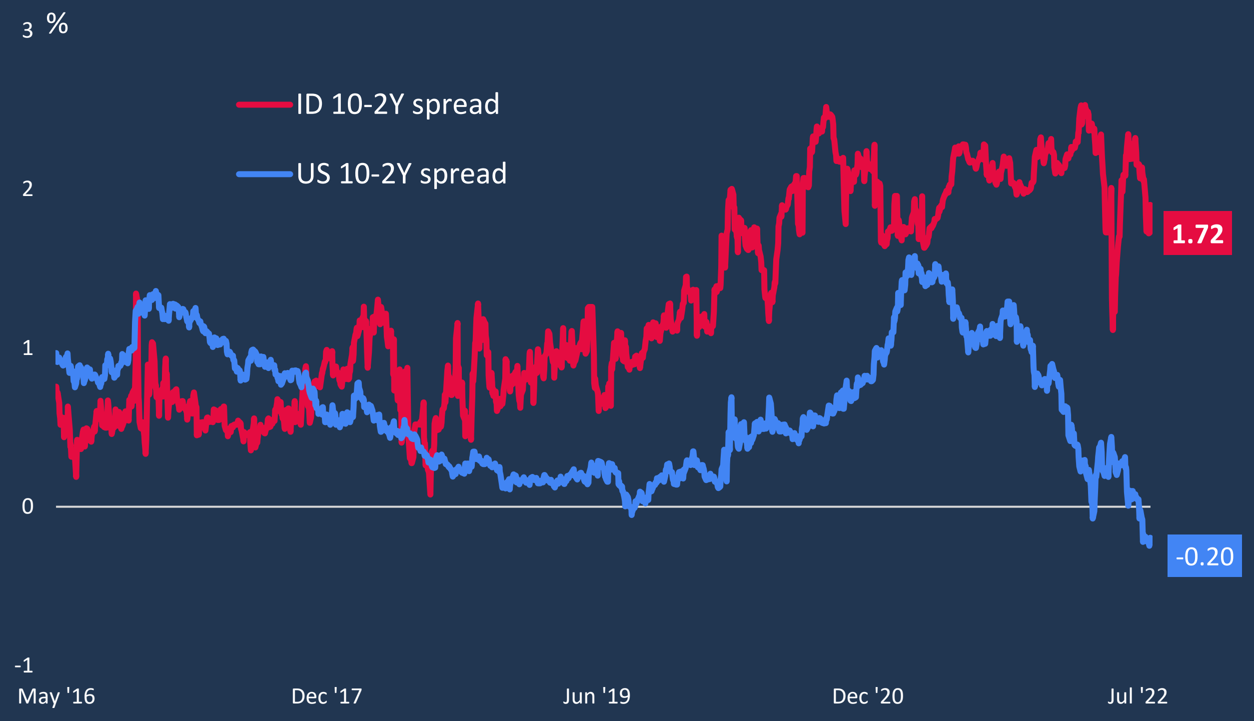
- Thus far, Indonesia still comfortably sits behind the monetary tightening curve, unbothered by the watershed of surprise rate hikes in neighbouring central banks. Thanks to its trade surplus and robust FX reserves, Indonesia still enjoys some luxuries that separate it from the more precarious conditions faced by other emerging economies. This may well begin to change if the threat from King Dollar continues to grow and outweigh the (potentially declining) commodity windfall.

- Fortunately, as we noted in our previous report, Bank Indonesia's lack of rate hike action does not mean that it is entirely passive. There are, of course, adjustments to the reserve requirement ratio (RRR), which will reach an all-time high of 9% by September. After that, BI's next move to curtail excess liquidity and external risks involves a sell-off of IDR 70 Tn worth of short-to-long-term government bonds (maturing in 0 – 5 years). This policy experiment has so far shown promising results in raising short-term yields ***(Chart 3)***, providing incentives for financial institutions to pick up where BI left off.

- Furthermore, BI is orchestrating an orderly draining of liquidity thus far. It could have been the case that government bond yields spike too rapidly, if banks were unable to absorb the bonds that BI are selling. Instead, banks' holding of bonds have actually increased ***(Chart 4)***, and the drain in liquidity happens instead to banks' placement at BI instruments, which are receding to levels unseen since September 2020 ***(Chart 5).*** This is important, as sapping excess liquidity out of the market is essential to suppress monetary inflation, a potential weak point that further threatens the IDR's value in the face of the strengthening USD.

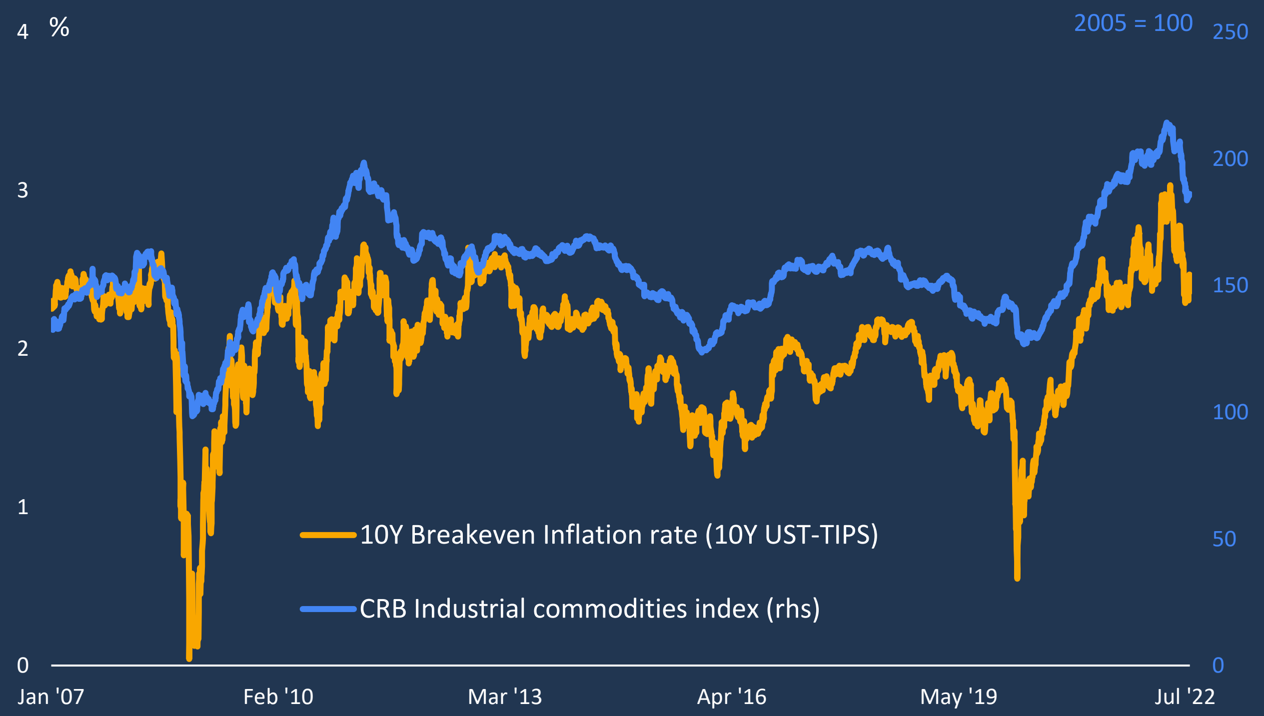
- BI's cocktail of monetary policy experiments, starting with scheduled RRR hikes, targeted market interventions, and gradual sell-off of government bonds, has managed to maintain the Rupiah exchange rate relative to the USD from breaking loose from the 15,000/USD psychological barrier. However, unless there is a clear sign of a Fed pivot by September, the risk of further outflows and strengthening of the Dollar remains quite likely. Thus, as we've argued ad nauseam, some measure of policy rate hikes would provide BI with a more direct and cost-efficient tool to defend against currency depreciation risks in the wake of a much stronger USD. Hence, we maintain our call that the BI 7DRR might still end the year 75 – 125 bps higher than the current level.

Chart 1. Persistently high inflation leads to the market increasingly calling for a US recession …



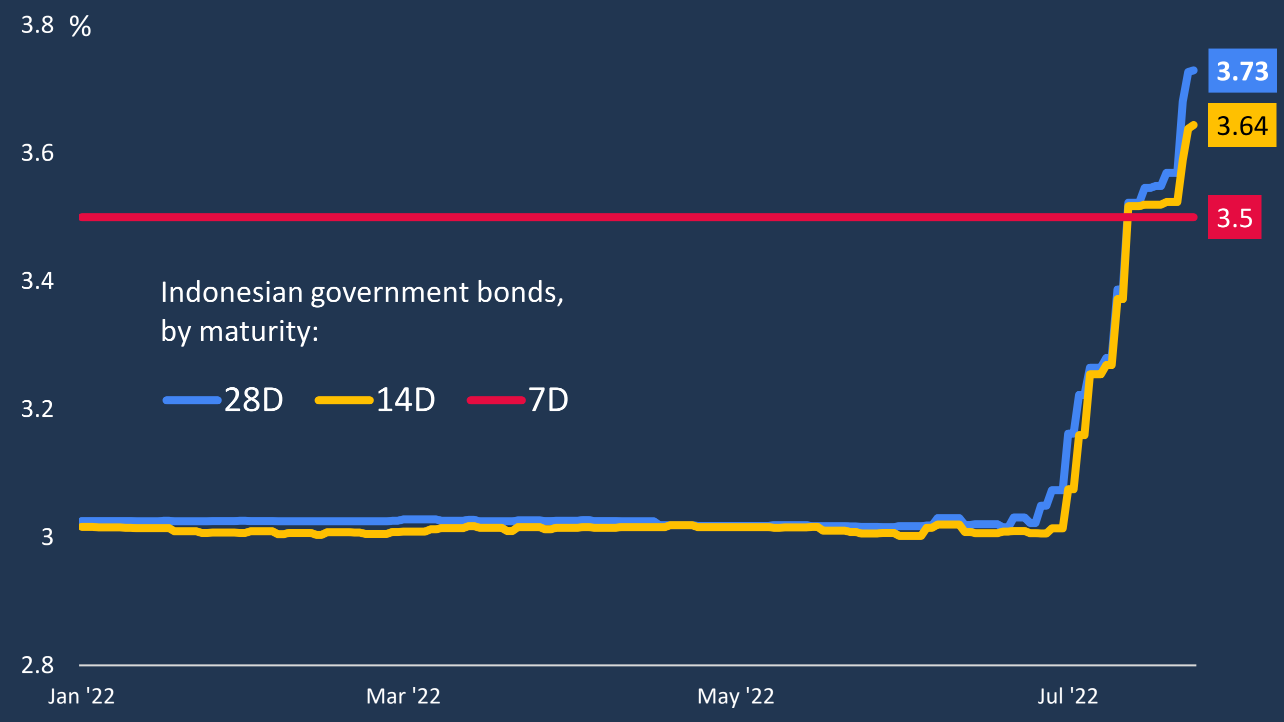
Source: Bloomberg

Chart 2. …while the recent downturn in commodity prices and the US breakeven inflation rate points to the same conclusion.



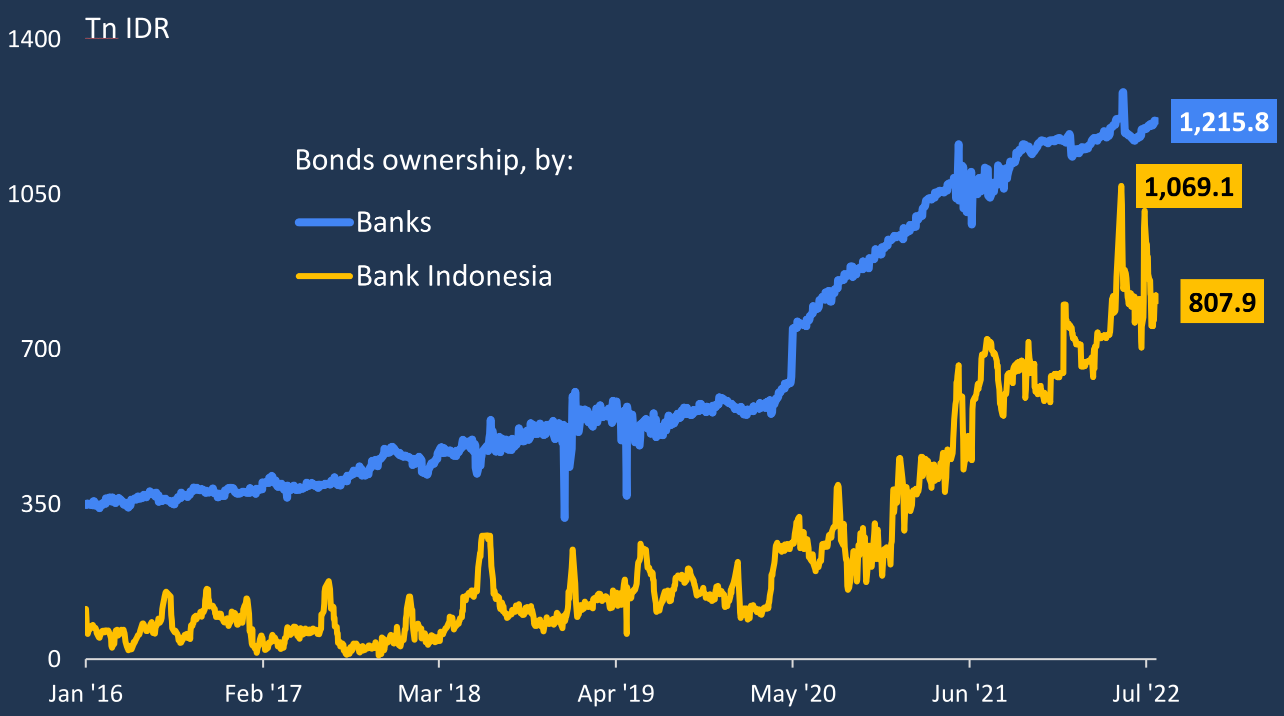
Source: Bloomberg

Chart 3. Yields on short-term bonds have begun to increase, courtesy of BI's recent policy experiment



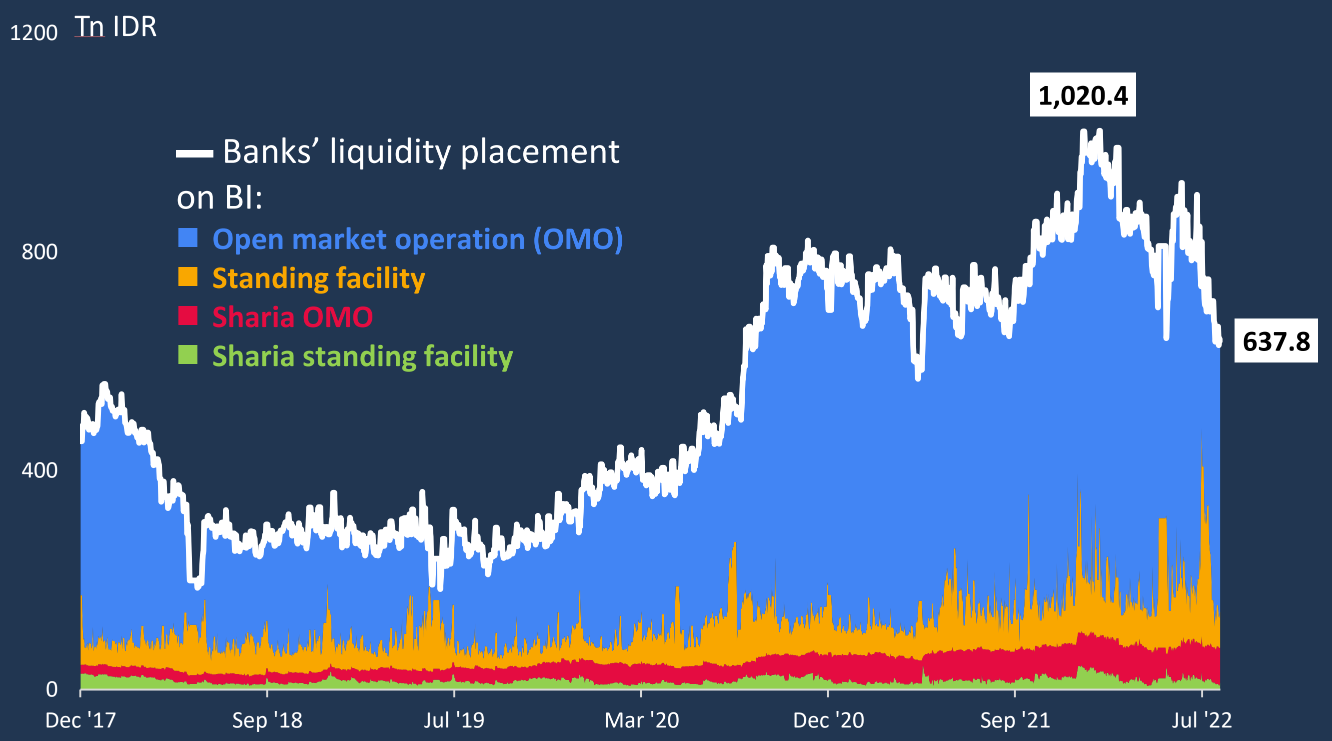
Source: BI

Chart 4. BI's liquidity drain have panned out seamlessly so far as banks prove to be eager to hold onto government bonds despite higher RRR



Source: MoF

Chart 5. Drain in liquidity happens instead to banks' liquidity placement at BI instruments



Source: BI

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	1.75	Jun-22	-7.35
UK	1.25	Jun-22	-8.15
EU	0.00	Mar-16	-8.60
Japan	-0.10	Jan-16	-2.50
China (lending)	4.35	Oct-15	1.85
Korea	2.25	Jul-22	-3.75
India	4.90	Jun-22	-2.11
Indonesia	3.50	Feb-21	-0.85

Money Mkt Rates	27-Jul	-1 mth	Chg (bps)
SPN (1M)	2.03	2.32	-29.2
SUN (10Y)	7.35	7.31	4.2
INDONIA (O/N, Rp)	2.80	2.80	0.2
JIBOR 1M (Rp)	3.63	3.54	8.5

Bank Rates (Rp)	Mar	Feb	Chg (bps)
Lending (WC)	8.59	8.62	-2.97
Deposit 1M	2.85	2.85	0.57
Savings	0.63	0.63	-0.23

Currency/USD	27-Jul	-1 mth	Chg (%)
UK Pound	0.823	0.815	-0.90
Euro	0.980	0.948	-3.35
Japanese Yen	136.6	135.2	-0.98
Chinese RMB	6.759	6.690	-1.02
Indonesia Rupiah	15,012	14,848	-1.09

Capital Mkt	27-Jul	-1 mth	Chg (%)
JCI	6,898.2	7,042.9	-2.05
DJIA	32,197.6	31,500.7	2.21
FTSE	7,348.2	7,208.8	1.93
Nikkei 225	27,715.8	26,492.0	4.62
Hang Seng	20,670.0	21,719.1	-4.83

Foreign portfolio ownership (Rp Tn)	Jun	May	Chg (Rp Tn)
Stock	2,388.2	2,503.9	-115.73
Govt. Bond	780.2	795.7	-15.51
Corp. Bond	17.9	18.1	-0.16

Trade & Commodities	27-Jul	-1 mth	Chg (%)
Baltic Dry Index	2,007.0	2,331.0	-13.9
S&P GSCI Index	684.0	735.0	-6.9
Oil (Brent, $/brl)	106.6	113.1	-5.7
Coal ($/MT)	411.2	358.8	14.6
Gas ($/MMBtu)	8.65	5.95	45.4
Gold ($/oz.)	1,734.2	1,826.9	-5.1
Copper ($/MT)	7,627.3	8,381.0	-9.0
Nickel ($/MT)	21,754.0	22,359.5	-2.7
CPO ($/MT)	866.0	1,084.7	-20.2
Rubber ($/kg)	1.52	1.59	-4.4

External Sector	Jun	May	Chg (%)
Export ($ bn)	26.09	21.51	21.3
Import ($ bn)	21.00	18.61	12.9
Trade bal. ($ bn)	5.09	2.90	
Central bank reserves ($ bn)*	136.4	135.6	0.63

Prompt Indicators	Jun	May	Apr
Consumer confidence index (CCI)	128.2	128.9	113.1
Car sales (%YoY)	8.9	-9.8	5.0
Motorcycle sales (%YoY)	-30.9	-2.5	-7.1
Cement sales (%YoY)	#N/A	7.6	-10.0

Manufacturing PMI	Jun	May	Chg (bps)
USA	53.0	56.1	-310
Eurozone	52.1	54.6	-250
Japan	52.7	53.3	-60
China	51.7	48.1	360
Korea	51.3	51.8	-50
Indonesia	50.2	50.8	-60

Source: Bloomberg, BI, BPS

Notes:

^Data for January 2022

*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$)	3877	3927	4175	3912	4350	4615
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	4.7
BI 7 day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	4.50
USD/IDR Exchange Rate (end of year)**	13,433	14,390	13,866	14,050	14,262	15,070
Trade Balance (US$ billion)	11.8	-8.5	-3.2	21.7	35.3	39.2
Current Account Balance (% GDP)	-1.6	-3.0	-2.7	-0.4	0.3	0.9

* Provisional numbers for 2021

** Estimation of Rupiah's fundamental exchange rate

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