

## BI Policy:

# It's tightening by stealth again

Keely Julia Hasim  
Economist/Analyst

Barra Kukuh Mamia  
Senior Economist

24 May 2022

### Executive Summary

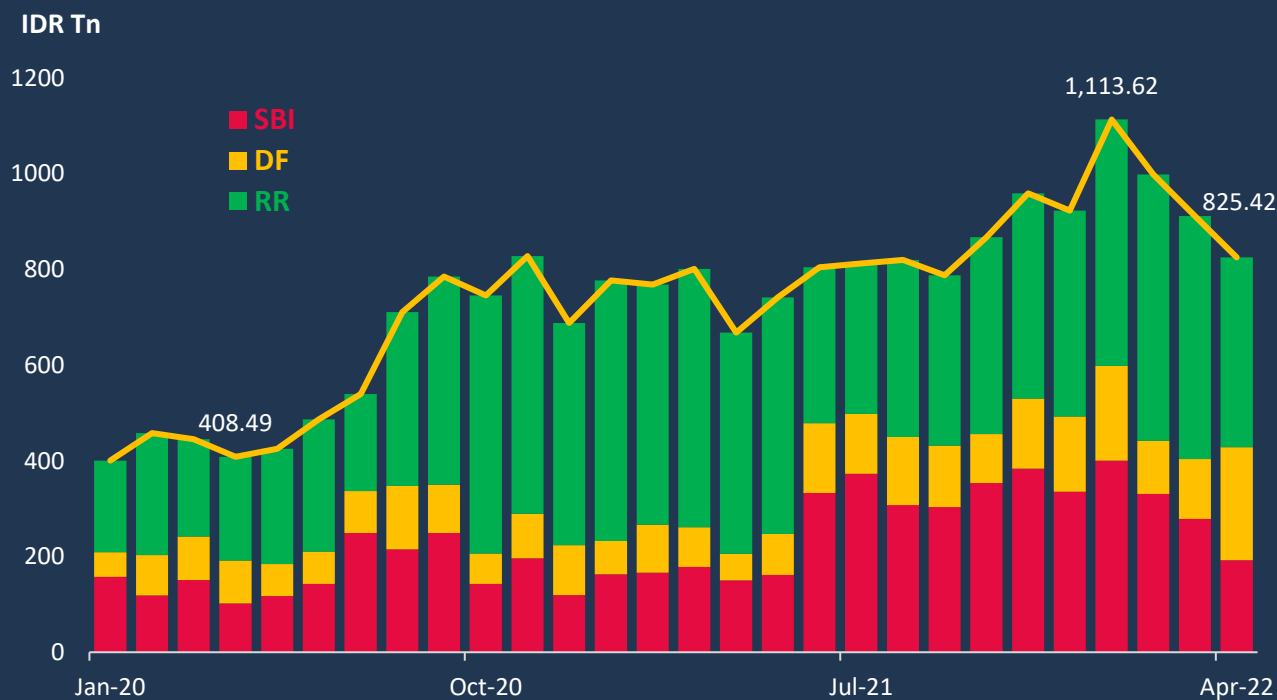
- Bank Indonesia held the 7-Day Reverse Repo Rate (BI7DRR) at 3.50%, in line with market consensus. Despite this seemingly dovish decision, BI has also changed the reserve ratio (RRR) schedule for the second time.
  - While hiking the RRR may be appropriate to curtail the recent rapid loan growth, its efficacy in maintaining Rupiah's stability – as opposed to a straightforward rate hike -- will have to be seen in the coming months.
  - As such, we still expect some measure of BI7DRR hikes in the coming months (50 – 150 bps for the year) especially if the Dollar continues to strengthen amid the Fed's tightening.
- Bank Indonesia (BI) maintained its 7-Day Reverse Repo Rate (BI7DRR) at 3.50%, in line with the market consensus. Despite this seemingly dovish decision – especially compared to other central banks – BI also changed the reserve requirement ratio (RRR) schedule for the second time, meaning that BI is not being so dovish after all.
  - Instead of an RRR hike schedule of 6.0% (starting June) and then 6.5% (starting September), the RRR trajectory is now increased to 6.0% (June), 7.5% (July), and finally 9.0% (September). This means that Rupiah liquidity available for loans would be reduced by an additional Rp 174 – 187 Tn for the year, on top of the earlier reduction (**Chart 1**). The move is certainly appropriate given the rapid loan growth (9.1% YoY in April), but its efficacy in maintaining Rupiah stability – as opposed to a straightforward rate hike – will have to be seen in the coming months.
  - The main pathway by which RRR hikes can strengthen Rupiah is by curtailing loan growth, and therefore, demand. This would serve to slow inflation and eventually slow down import growth, which would also improve the balance of payment. However, both of these effects would probably only materialize after a few quarters, especially given how strong demand currently runs. In other words, the transmission of RRR hike towards Rupiah takes a relatively long time.
  - This stands in contrast to BI7DRR hike, which would influence both cost of funds and market perceptions instantaneously. As we mentioned in our last report on BoP, real policy rate has had better correlation with EM exchange rates year-to-date, and the lack of a rate hike by BI could be a partial explanation as to why the Rupiah has weakened despite Indonesia's clearly bright current account prospects. As such, we still expect some measure of BI7DRR hikes in

the coming months (50 – 150 bps for the year) especially if the Dollar continues to strengthen amid the Fed's tightening of its money spigot.

- Fortunately for BI, there are a couple of good news that may make its job easier as well. The first is obviously last week's decision by the government to increase energy subsidies, in lieu of price adjustments. This should help anchor inflation outlook to the 3.5 – 5.0% band (our current forecast is at 4.1 – 4.6% YoY), and thus maintain a positive – or at least neutral – real policy rate. There are, to be fair, a few black swans that might still result in acute inflationary pressure, particularly with respect to foodstuffs. Dry weather in South Asia – where 75% of Indonesia's rice imports are coming from – as well as soaring fertilizer costs could result in significant food inflation, which may be only partially remedied by government intervention.
- It is also important to note that the government did not expect an increase in its fiscal deficit as a result of the increase subsidies, thanks to the substantial commodity windfall. But while we do arrive at a figure quite close to the government's estimates for an oil price of USD 100/barrel, we also calculate that as oil price increases, the growth of subsidies would outpace the growth of windfall. This means an oil price of USD 120 or higher could increase the deficit beyond 5% of the GDP. Fortunately, the fact that BI has chosen RRR hikes instead of BI7DRR hikes should help stabilize government financing costs in the short-term.
- The second good news is the increasing likelihood that the Fed's current tightening cycle may end sooner – and at a lower terminal rate – than previously expected. One Fed official has in fact mentioned that it "might make sense" for the Fed to pause further interest rate hikes following expected 50 bps increases over the next two months. While investors still expect the Fed to continue raising rates to around 2.75-3.00% (i.e. around four more 50 bps rate hikes) by the end of this year (**Chart 2**), the slight decline in the Fed Funds Futures suggests that markets have also started to price in US economic slowdown and therefore an earlier end to Fed hikes. While this is not a majority opinion within the Fed as yet, such views could help moderate the strength of the USD as well as the capital outflows from Indonesia, which reached its peak frenzy earlier this month.

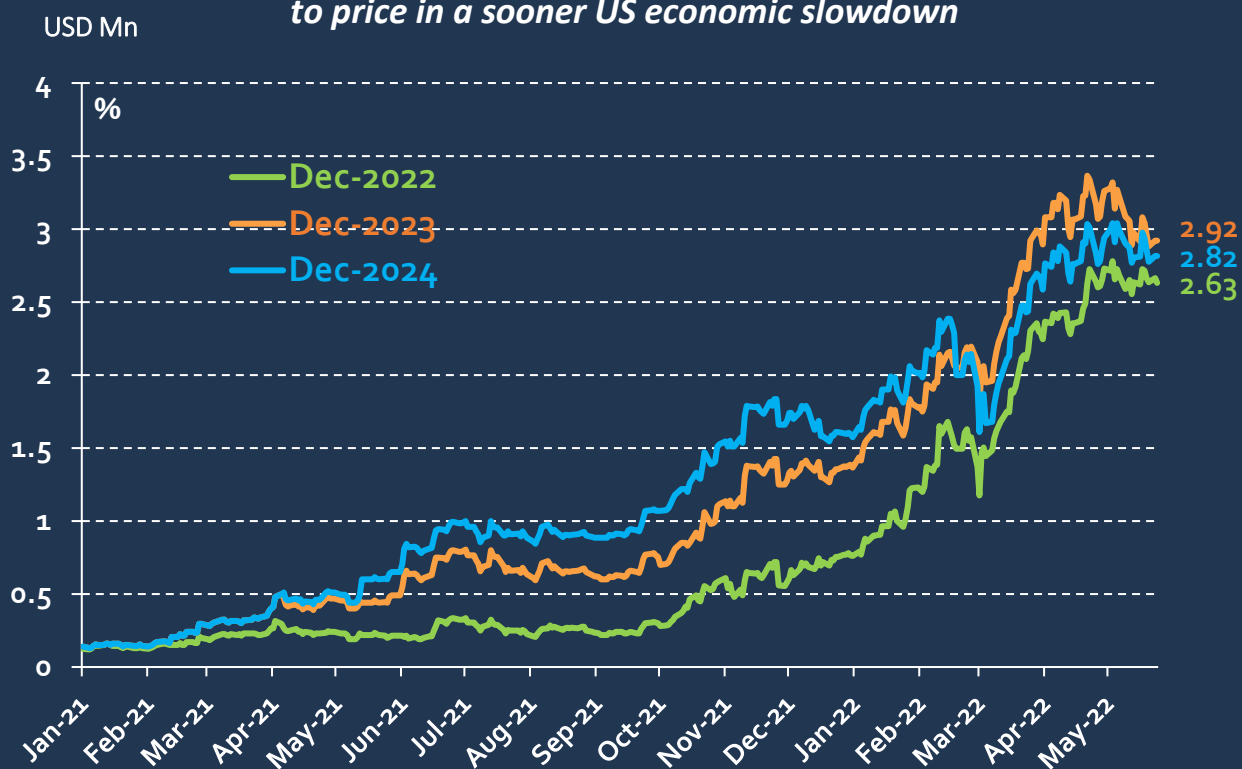
**"The RRR hike stands in contrast to the BI7DRR hike, which would influence both cost of funds and market perceptions instantaneously."**

**Chart 1. Banks' excess liquidity has begun to decline following the first round of RRR hike in March**



Source: Bank Indonesia

**Chart 2. The slight decline in the Fed Funds Futures suggests that markets have started to price in a sooner US economic slowdown**



Source: Bloomberg (last update: 24 May 2022)

## Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	23-May	-1 mth	Chg (%)
US	0.50	Mar-22	-7.80	Baltic Dry Index	3,369.0	2,307.0	46.0
UK	0.75	Mar-22	-8.25	S&P GSCI Index	772.2	745.0	3.6
EU	0.00	Mar-16	-7.40	Oil (Brent, \$/bbl)	113.4	106.7	6.3
Japan	-0.10	Jan-16	-2.60	Coal (\$/MT)	383.1	338.1	13.3
China (lending)	4.35	Oct-15	2.25	Gas (\$/MMBtu)	8.26	6.59	25.3
Korea	1.50	Apr-22	-3.30	Gold (\$/oz.)	1,853.6	1,931.6	-4.0
India	4.40	May-22	-3.39	Copper (\$/MT)	9,588.5	10,113.3	-5.2
Indonesia	3.50	Feb-21	0.03	Nickel (\$/MT)	27,693.0	33,069.0	-16.3
Money Mkt Rates	23-May	-1 mth	Chg (bps)	CPO (\$/MT)	1,528.9	1,569.7	-2.6
				Rubber (\$/kg)	1.61	1.65	-2.4
SPN (1M)	3.89	2.19	170.1	External Sector	Apr	Mar	Chg (%)
SUN (10Y)	7.16	6.98	18.6	Export (\$ bn)	27.32	26.50	3.1
INDONIA (O/N, Rp)	2.79	2.79	0.0	Import (\$ bn)	19.76	21.96	-10.0
JIBOR 1M (Rp)	3.54	3.55	-0.5	Trade bal. (\$ bn)	7.56	4.54	
Bank Rates (Rp)	Feb	Jan	Chg (bps)	Central bank reserves (\$ bn)*	135.7	139.1	-2.46
Lending (WC)	8.62	8.66	-3.55	Prompt Indicators	Apr	Mar	Feb
Deposit 1M	2.85	2.88	-3.49	Consumer confidence index (CCI)	113.1	111.0	113.1
Savings	0.63	0.69	-6.27	Car sales (%YoY)	5.0	16.0	65.1
Currency/USD	23-May	-1 mth	Chg (%)	Motorcycle sales (%YoY)	-7.1	-13.6	-2.6
UK Pound	0.794	0.779	-1.95	Cement sales (%YoY)	N/A	23.2	13.6
Euro	0.935	0.927	-0.92	Capital Mkt	23-May	-1 mth	Chg (%)
Japanese Yen	127.9	128.5	0.47	JCI	6,840.8	7,225.6	-5.33
Chinese RMB	6.650	6.501	-2.23	DJIA	31,880.2	33,811.4	-5.71
Indonesia Rupiah	14,672	14,362	-2.11	FTSE	7,513.4	7,521.7	-0.11
Capital Mkt	23-May	-1 mth	Chg (%)	Nikkei 225	27,001.5	27,105.3	-0.38
				Hang Seng	20,470.1	20,638.5	-0.82
Foreign portfolio ownership (Rp Tn)	Apr	Mar	Chg (Rp Tn)	Manufacturing PMI	Apr	Mar	Chg (bps)
Stock	2,599.7	2,463.5	136.15	USA	55.4	57.1	-170
Govt. Bond	827.9	848.3	-20.43	Eurozone	55.5	56.5	-100
Corp. Bond	18.5	19.4	-0.92	Japan	53.5	54.1	-60
				China	46.0	48.1	-210
				Korea	52.1	51.2	90
				Indonesia	51.9	51.3	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	4.2
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

### Economic, Banking & Industry Research Team

**David E. Sumual**  
*Chief Economist*  
david\_sumual@bca.co.id  
+6221 2358 8000 Ext: 1051352

**Agus Salim Hardjodinoto**  
*Senior Industry Analyst*  
agus\_lim@bca.co.id  
+6221 2358 8000 Ext: 1005314

**Gabriella Yolivia**  
*Industry Analyst*  
gabriella\_yolivia@bca.co.id  
+6221 2358 8000 Ext: 1063933

**Keely Julia Hasim**  
*Economist / Analyst*  
Keely\_hasim@bca.co.id  
+6221 2358 8000 Ext: -

**Barra Kukuh Mamia**  
*Senior Economist*  
barra\_mamia@bca.co.id  
+6221 2358 8000 Ext: 1053819

**Derrick Gozal**  
*Economist / Analyst*  
derrick\_gozal@bca.co.id  
+6221 2358 8000 Ext: 1066722

**Lazuardin Thariq Hamzah**  
*Economist / Analyst*  
Lazuardin\_hamzah@bca.co.id  
+6221 2358 8000 Ext: -

**Arief Darmawan**  
*Research Assistant*  
arief\_darmawan@bca.co.id  
+6221 2358 8000 Ext: 20364

**Victor George Petrus Matindas**  
*Senior Economist*  
victor\_matindas@bca.co.id  
+6221 2358 8000 Ext: 1058408

**Livia Angelica Thamsir**  
*Economist / Analyst*  
livia\_thamsir@bca.co.id  
+6221 2358 8000 Ext: 1069933

**Ahmad Aprilian Rizki**  
*Research Assistant*  
ahmad\_rizki@bca.co.id  
+6221 2358 8000 Ext: 20378

### PT Bank Central Asia Tbk

#### Economic, Banking & Industry Research of BCA Group

20<sup>th</sup> Grand Indonesia, Menara BCA

Jl. M.H Thamrin No. 1, Jakarta 10310, Indonesia

Ph : (62-21) 2358-8000 Fax : (62-21) 2358-8343

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