

FX Reserves:

Can't fight the Fed

Lazuardin Thariq H.
Economist/Analyst

Barra Kukuh Mamia
Senior Economist

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Executive Summary

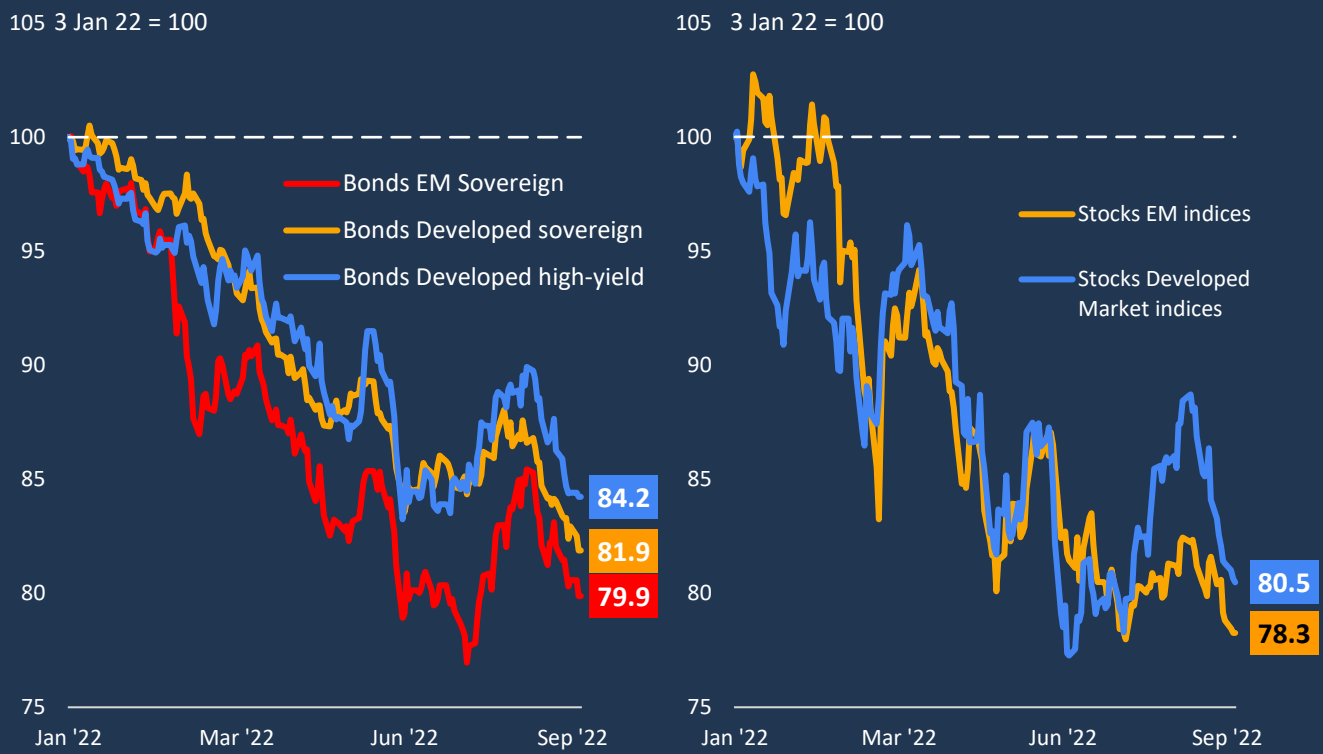
- FX reserves position stood unchanged at USD 132.2 Bn by the end of August 2022 as BI's interventions in the money market cancel out the increase in exports reception from higher coal and gas prices.
- Higher coal prices and BI's interventions in the Forex market appear to improve FX supply at home. However, FX demand in the domestic market remains robust, courtesy of recovering consumption and urgency among the business sector to expand.
- BI may still look to deliver another BI 7DRR hike to defend the IDR's value. Interventions in the Forex market are conditional on FX liquidity conditions in the domestic economy, while the prospect of foreign capital inflows appears somewhat limited.

- Bank Indonesia's official reserves asset position remained stable at USD 132.2 Bn by August 2022, unchanged from the previous month and equivalent to 6.1 months of imports or 6.0 months of imports and the government's external debt servicing. This figure remained the lowest since June 2020, as BI's intervention in the FX market negates the impact of higher gas and coal prices that should translate positively on the FX reserves.
- Despite the relatively calm days in early August 2022, the IDR (as well as other currencies) came under pressure again in the days following the Fed's Jackson Hole symposium. The FOMC chair Powell hit the mic in Jackson Hole with an Odyssean pledge to rein in inflation (The Fed is tying itself to the tightening mast despite the Siren song of weakening economic activity); markets react accordingly, snapping the July-August bull market rally as foreign capital flows out of risky markets (**Chart 1**). Fearing the risk of a more structural inflationary pressure, market participants are also of the opinion that the Fed would keep policy conditions tight for the foreseeable future (**Chart 2**). Indeed, the prospect of a 'tighter-for-longer' monetary condition would continue to strengthen the USD, adding to the cost BI would have to pay to protect the IDR's value through interventions in the FX market.
- On a further note, the tight US Dollar liquidity condition explains the continued sell-off of assets such as US treasury notes by emerging market investors, including Indonesian investors (**Chart 4**). Indeed, BI's lack of swap agreement with the Fed makes it difficult for domestic market participants to get hold of the greenbacks. US treasuries sell-off among emerging markets investors, of course, is parallel with the Fed's ongoing quantitative tightening. If left unattended, this condition may lead to spiking US treasury yields (akin to the spiking repo rate in 2019), leading to a policy setting much tighter than the Fed initially intended.

- BI's intervention in the FX market remains conditional on FX liquidity conditions at home. FX availability, however, appears to be improving in recent weeks. Climate anomalies and uncertain gas shipment in Europe have kept coal prices in its elevated state, a positive development for Indonesia's FX coffers. This development, of course, reflects our confidence in the upcoming trade balance number. Equally positive is that banks' FX placement at BI appears to be increasing lately, and the government's improved ability to extract commodity exporters' windfall profits (through higher coal and nickel export royalty tariffs) may help to increase FX liquidity in the domestic economy.
- However, demand for FX in the domestic market shows little evidence of slowing down. Readings on the latest purchasing managers' index data show that new orders from domestic consumers are still on its strong foot, strengthening the hypothesis that the business sector is under the urgency to scale up production activities. The domestic economy also has to grapple with USD 4.39 Bn worth of bonds that will mature sometime in 2022.
- The deciding factor, then, remains the foreign capital flows. Granted, foreign capital inflows into Indonesia's stock market remained buoyant, courtesy of positive sentiments derived from high coal prices. Alas, the prospect of foreign capital flowing into the domestic bond market appears rather grim. For one, the early August bond rally shows bond market participants' attentiveness to the Fed's policy signal. Historical data shows that monetary policy tightening in the US tends to end only after the policy rate delivers a positive real rate of return (**Chart 3**). The still-deeply negative real rate return may add to the argument for a prolonged tight money policy in the US, further limiting the prospect of significant capital inflows into Indonesia's bond market in the short term.
- Foreign investors also face lower incentives to find their way back to the Indonesian market. Uncertain global conditions aside, recent adjustments to subsidised fuel prices would increase inflationary pressures in Indonesia (which we now expect could end up above 7% by year's end), plunging the real rate return on Rupiah-denominated assets deeper into the red zone. With this calculus in mind, BI may have to tighten its policy further, with rate hikes to the tune of 75 – 100 bps by the end of 2022 appearing as the most sensible scenario for now.

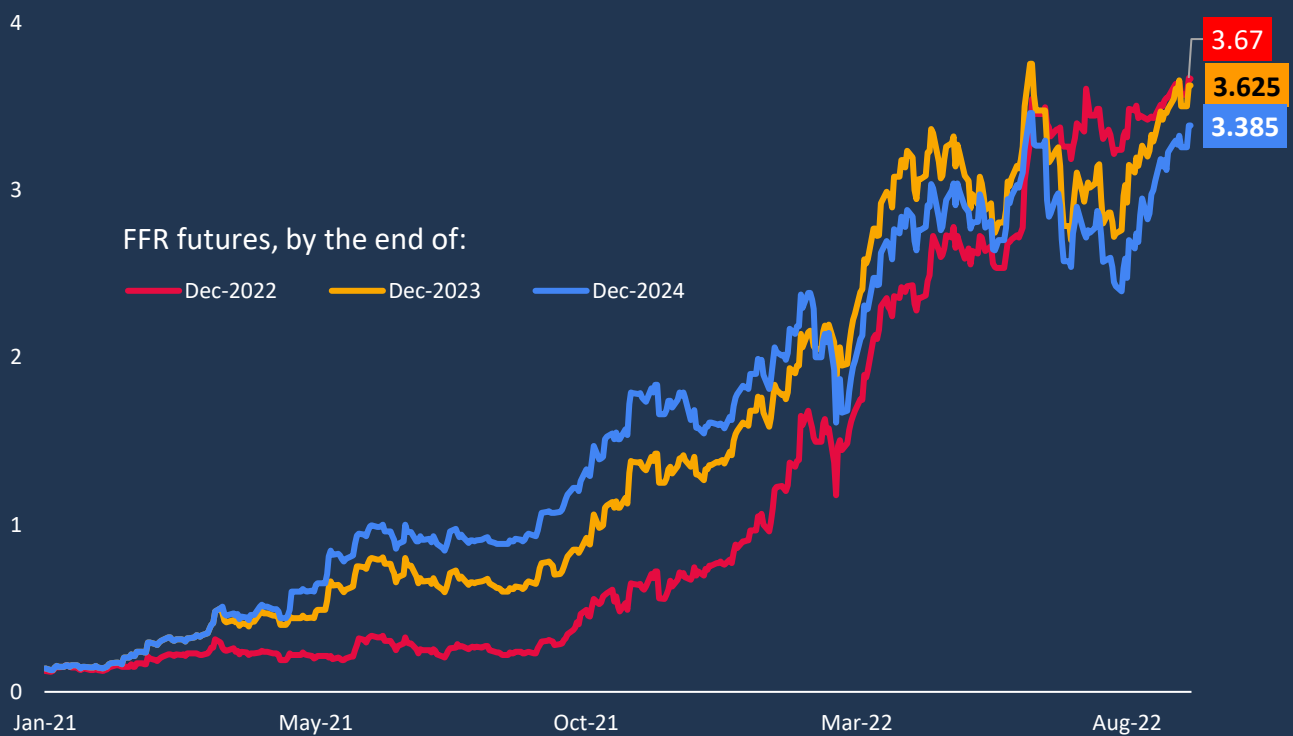
"Historical data shows that monetary policy tightening in the US tends to end only after the policy rate delivers a positive real rate of return"

Chart 1. Both stock and bond markets started to reverse its course in the days leading up to the 25-27 August 2022 Jackson Hole symposium ...



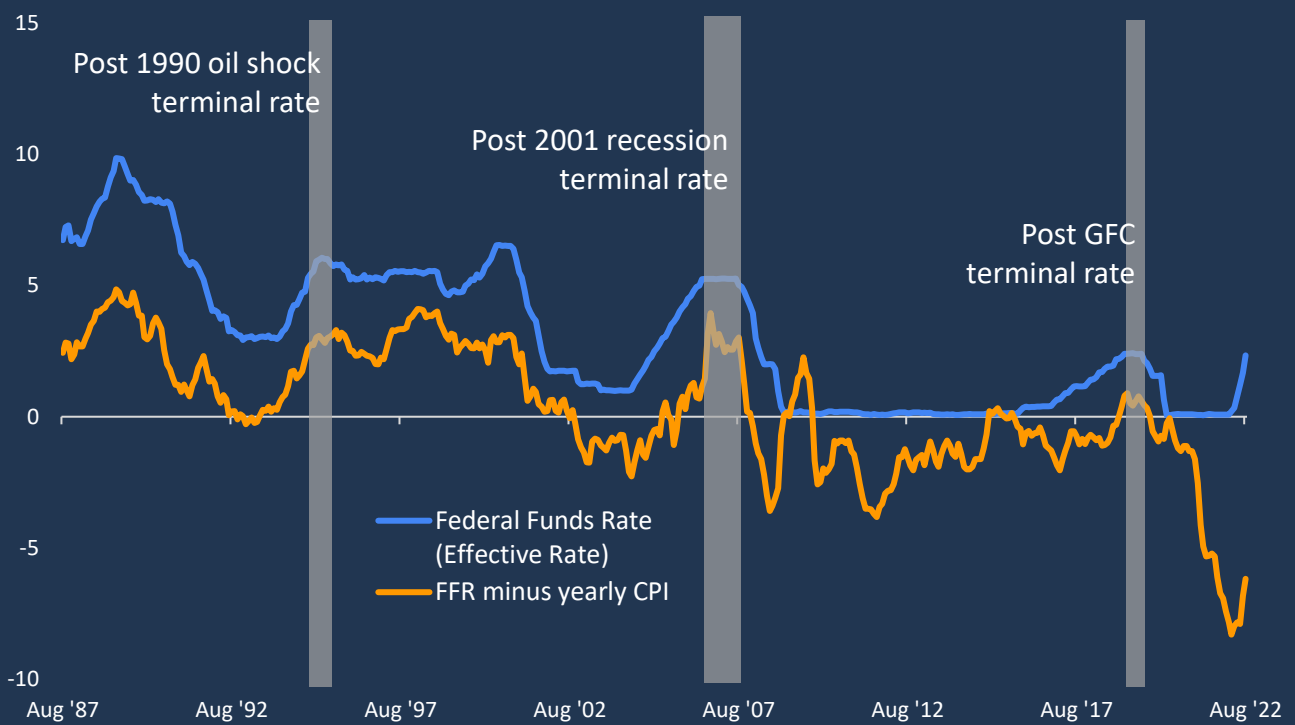
Source: Bloomberg

Chart 2. ...as market participants abandoning the expectation of a premature Fed pivot



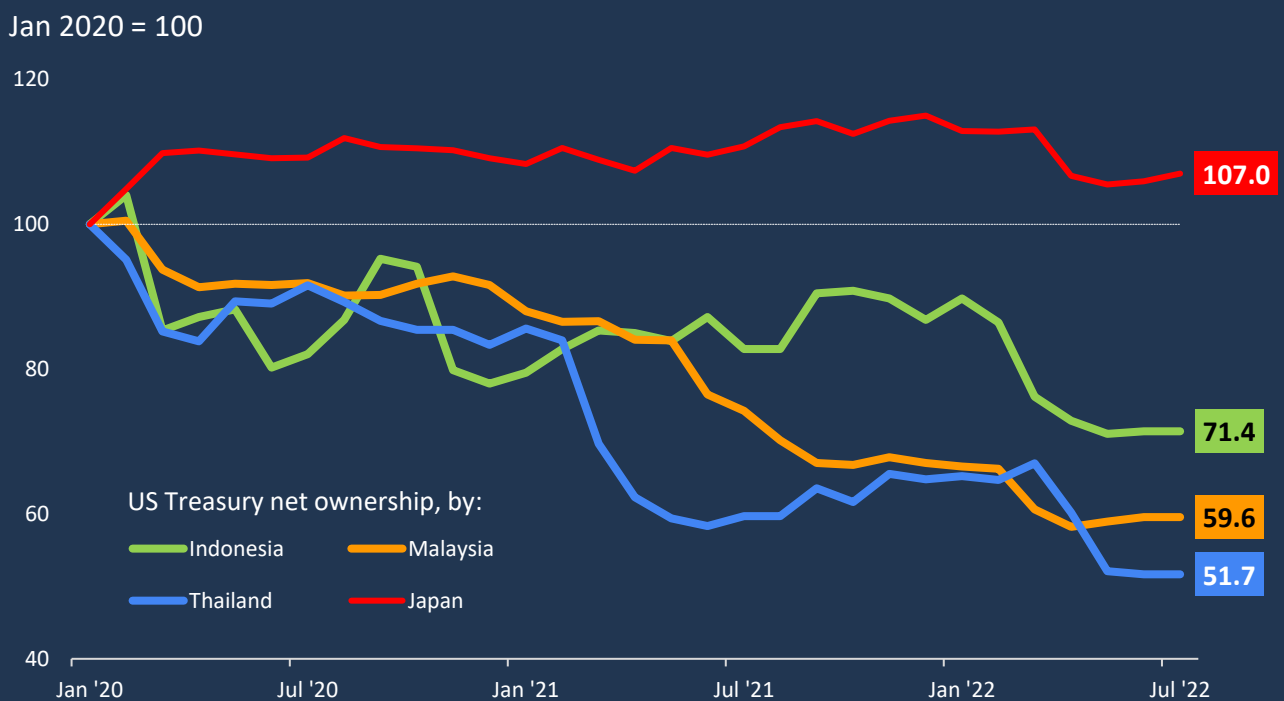
Source: Bloomberg

Chart 3. The Fed may continue to hike the federal funds rate to restore the positive real return on the policy rate



Source: Bloomberg

Chart 4. Tight USD liquidity leads to continued sell-offs of US treasuries, especially among EM-based investors



Source: Bloomberg

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	6-Sep	-1 mth	Chg (%)
US	2.50	Jul-22	-6.00	Baltic Dry Index	1,114.0	1,560.0	-28.6
UK	1.75	Aug-22	-8.35	S&P GSCI Index	647.7	649.3	-0.2
EU	0.50	Jul-22	-8.60	Oil (Brent, \$/bbl)	92.8	94.9	-2.2
Japan	-0.10	Jan-16	-2.70	Coal (\$/MT)	451.3	334.1	35.1
China (lending)	4.35	Oct-15	1.65	Gas (\$/MMBtu)	8.48	8.16	3.9
Korea	2.50	Aug-22	-3.20	Gold (\$/oz.)	1,702.1	1,775.5	-4.1
India	5.40	Aug-22	-1.31	Copper (\$/MT)	7,751.0	7,862.5	-1.4
Indonesia	3.75	Aug-22	-0.94	Nickel (\$/MT)	21,532.0	22,151.0	-2.8
Money Mkt Rates	6-Sep	-1 mth	Chg (bps)	CPO (\$/MT)	853.1	908.0	-6.0
				Rubber (\$/kg)	1.29	1.52	-15.1
SPN (1M)	2.18	2.38	-20.0	External Sector	Jul	Jun	Chg (%)
SUN (10Y)	7.15	7.14	1.1	Export (\$ bn)	25.57	26.15	-2.2
INDONIA (O/N, Rp)	3.25	2.80	45.1	Import (\$ bn)	21.35	21.00	1.6
JIBOR 1M (Rp)	4.11	3.76	35.7	Trade bal. (\$ bn)	4.23	5.15	
Bank Rates (Rp)	May	Apr	Chg (bps)	Central bank reserves (\$ bn)*	132.2	136.4	-3.06
Lending (WC)	8.48	8.49	-1.13	Prompt Indicators	Jul	Jun	May
Deposit 1M	2.79	2.84	-4.96	Consumer confidence index (CCI)	123.2	128.2	128.9
Savings	0.64	0.62	1.17	Car sales (%YoY)	29.4	8.5	-9.3
Currency/USD	6-Sep	-1 mth	Chg (%)	Motorcycle sales (%YoY)	-13.3	-30.9	-2.5
UK Pound	0.868	0.828	-4.58	Cement sales (%YoY)	#N/A	-41.1	7.6
Euro	1.010	0.982	-2.74				
Japanese Yen	142.8	135.0	-5.46				
Chinese RMB	6.955	6.762	-2.77				
Indonesia Rupiah	14,887	14,893	0.04				
Capital Mkt	6-Sep	-1 mth	Chg (%)	Manufacturing PMI	Aug	Jul	Chg (bps)
JCI	7,233.2	7,084.7	2.10	USA	52.8	52.8	0
DJIA	31,145.3	32,803.5	-5.05	Eurozone	49.6	49.8	-20
FTSE	7,300.4	7,439.7	-1.87	Japan	51.5	52.1	-60
Nikkei 225	27,626.5	28,175.9	-1.95	China	49.5	50.4	-90
Hang Seng	19,202.7	20,201.9	-4.95	Korea	47.6	49.8	-220
Foreign portfolio ownership (Rp Tn)	Aug	Jul	Chg (Rp Tn)	Indonesia	51.7	51.3	40
Stock	2,541.6	2,442.4	99.11				
Govt. Bond	759.5	751.2	8.27				
Corp. Bond	15.2	16.7	-1.50				

Source: Bloomberg, BI, BPS

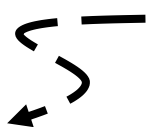
Notes:

^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



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Indonesia – Economic Indicators Projection

	2017	2018	2019	2020	2021	2022E
Gross Domestic Product (% YoY)	5.1	5.2	5.0	-2.1	3.7	5.1
GDP per Capita (US\$)	3877	3927	4175	3912	4350	4564
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	7.1
BI 7 day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	4.75
USD/IDR Exchange Rate (end of year)**	13,433	14,390	13,866	14,050	14,262	15,293
Trade Balance (US\$ billion)	11.8	-8.5	-3.2	21.7	35.3	36.9
Current Account Balance (% GDP)	-1.6	-3.0	-2.7	-0.4	0.3	0.5

** 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

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

Agus Salim Hardjodinato

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

Lazuardin Thariq Hamzah

Economist / Analyst

lazuardin_hamzah@bca.co.id

+6221 2358 8000 Ext: 1071724

Arief Darmawan

Research Assistant

arief_darmawan@bca.co.id

+6221 2358 8000 Ext: 20364

Barra Kukuh Mamia

Senior Economist

barra_mamia@bca.co.id

+6221 2358 8000 Ext: 1053819

Suryaputra Wijaksana

Economist / Analyst

suryaputra_wijaksana@bca.co.id

+6221 2358 8000 Ext: 1065752

Keely Julia Hasim

Economist / Analyst

keely_hasim@bca.co.id

+6221 2358 8000 Ext: 1071535

PT Bank Central Asia Tbk

Economic, Banking & Industry Research of BCA Group

20th 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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