

FX Reserves:

A dwindling arsenal amidst persistent risks

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Executive Summary

- BI's FX reserves position declined to USD 130.8 Bn by the end of September 2022. BI's intervention in the FX market and external debt payment appears to outweigh last month's global bond issuance by the government.
- FX liquidity within the domestic banking remains limited despite the 50bps increase in LPS rate for foreign saving accounts. In contrast, demand for FX in the domestic market shows little evidence of slowing down.
- Indonesia's bond market remains stable amid the recent global bond sell-off. However, pressures remain as the Fed's steeper rate hike trajectory may widen the policy rate spread between BI and the Fed.

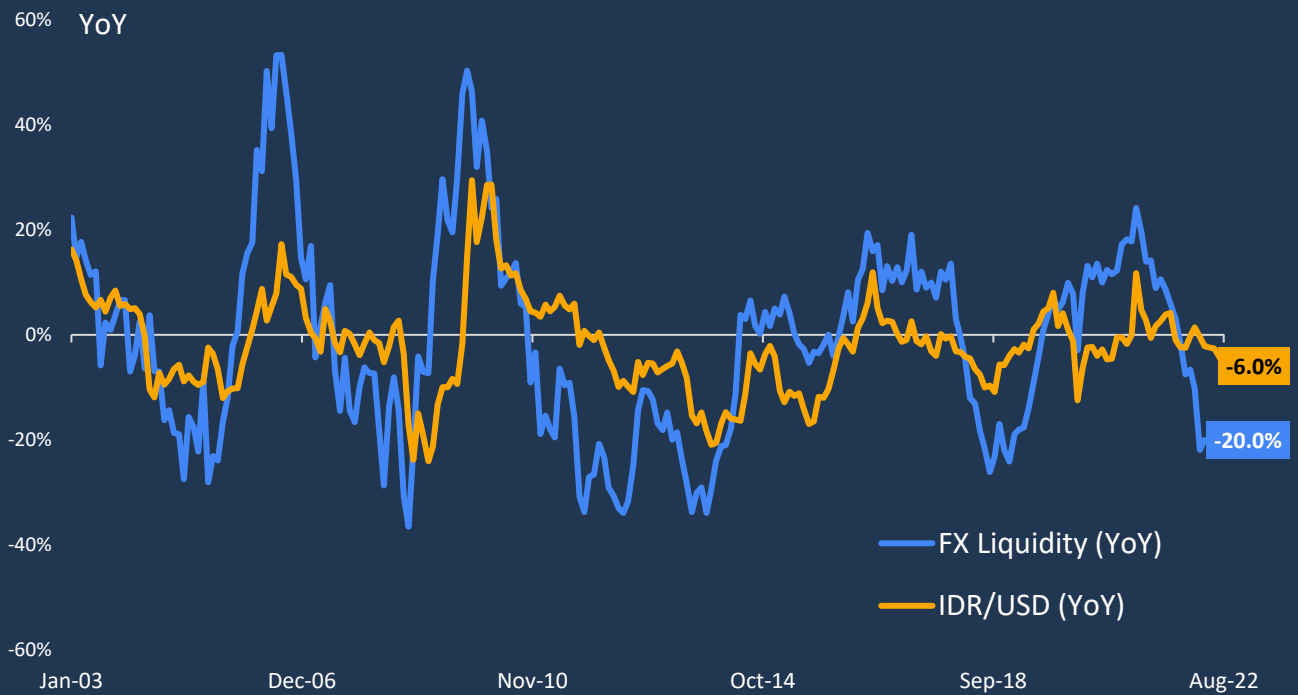
- Bank Indonesia's official reserves asset position stood at USD 130.8 Bn by the end of September 2022, declining slightly from USD 132.2 Bn in August 2022. This decline occurred despite the government's USD 2.8 Bn global bond issuance last month as BI grappled with upticks of uncertainty in the global financial market while the government was hit by external debt repayment. BI's FX reserves position remains ample, although the current reserves-to-import coverage (5.9) marks the lowest level since July 2013.
- A higher import number is not a bad sign. For one, strong confidence in the economy often translates to higher imports of machinery as businesses look to expand their productive capacity. However, too-high imports combined with lower FX reserves position could undermine the presently positive sentiment in the IDR. Continued exuberance in Indonesia's import growth, either due to the purchase of capital goods or energy commodities, may stretch FX liquidity in the domestic economy, especially if domestic banks continue to face double-digit demand for FX loans (**Chart 1**).
- The prospect of improving FX availability in the domestic economy remains limited. The sizable interest rate differential between Indonesian and foreign banks causes foreign currencies to continue to escape the grip of local banks, limiting FX availability in the domestic banking system. Indeed, Indonesia's deposit insurance authority (LPS) had raised the guaranteed rates on FX savings by 50 bps to 0.75%. But this adjustment is, arguably, minuscule compared to rates offered by overseas banks that are closer to the Fed's.
- Another thing to consider is that USD deposits within the Indonesian banking system are locked in a handful of accounts, courtesy of the uneven distribution of hard currencies liquidity across sectors. This situation reflects the uncertainty concerning FX availability in the domestic banking

sector, as the availability of external financing would depend on the whims of a small club of depositors.

- Of course, banks could always mitigate the uncertain US Dollar liquidity condition by looking outward, either by borrowing from foreign banks or through global bond issuance – something that we’ve seen throughout the first half of the year. However, this is an increasingly expensive strategy given the Fed’s continuing rate hike. Lower FX liquidity may encourage banks to be more conservative in providing external financing. In contrast, limited FX financing availability would lead to increasing reluctance among Indonesia’s hard currencies-getter to convert their FX revenue for IDR. Consequentially, there are arguably two ways out of this impasse: either the IDR depreciates further, or the domestic demand for USD (i.e., for imports) has to slow down. Depreciating IDR may entice BI to draw down its FX reserves to stabilise the IDR’s value.
- Spending reserves on FX market intervention looks, increasingly, mainly as a means of smoothing day-to-day exchange rate fluctuations rather than arresting depreciation outright. We should be aware that reserves are more useful as a deterrent; further declines in the reserves-to-imports ratio may presage further depreciation, as we saw in the 2013 ‘taper tantrum’ occurrence.
- Another factor limiting Indonesia’s FX reserves position is the continuing foreign capital outflows in the domestic bond market, which had accumulated to shy of USD 9.8 Bn compared to the position earlier in the year (**Chart 2**). Granted, bond market sell-off is not an exclusively Indonesia or emerging markets problem, evident from the recent tumult in the UK gilt market. Indeed, a more attractive yield on US-backed securities may increase yield-seeking investors’ appetite for US financial assets, a contributing factor to the recent global bond sell-offs.
- Indonesia, if anything, is one of the few countries that managed to emerge from the global bond rout relatively unscathed. Indonesian bonds only lost 3.64% of its value throughout the worldwide sell-off in Q3 2022, offering shelter from extreme volatility in global markets thanks to the healthy spread between Indonesian and US bonds. Despite this relative strength, however, the domestic bond market is still under some pressure. Uncertain global conditions aside, increasing inflationary pressures would suppress the real-rate return on Rupiah-denominated bonds, reducing the incentive for foreign investors to find their way back to the Indonesian market. BI’s softer rate hike trajectory would also widen the policy rate spread between BI and the Fed, adding to the selling pressure on the Indonesian market.
- Some may argue that we are already close to the ‘peak dollar’ situation, as evidence of a weakening US labour market and softening economic activities are starting to emerge. There are also concerns that higher interest rates would limit the US and global corporates’ ability to roll over their debt, which may worsen the upcoming economic slump. However, the great inflation period of 1965-1982 shows that a ‘stop-and-go’ policy is ineffectual in whipping the inflation down, worsening the inflationary dynamics that lead to economic stress. FOMC chair Powell is, of course, well aware of this history, as evident from the September FOMC meeting’s dot plot that signals FOMC’s tighter-for-longer policy outlook. Continued US monetary policy tightening reflects the depreciation risk faced by the IDR, and policy rate increases to the tune of 50-100 bps throughout the rest of 2022 may help BI in its efforts to maintain the stability of the IDR.

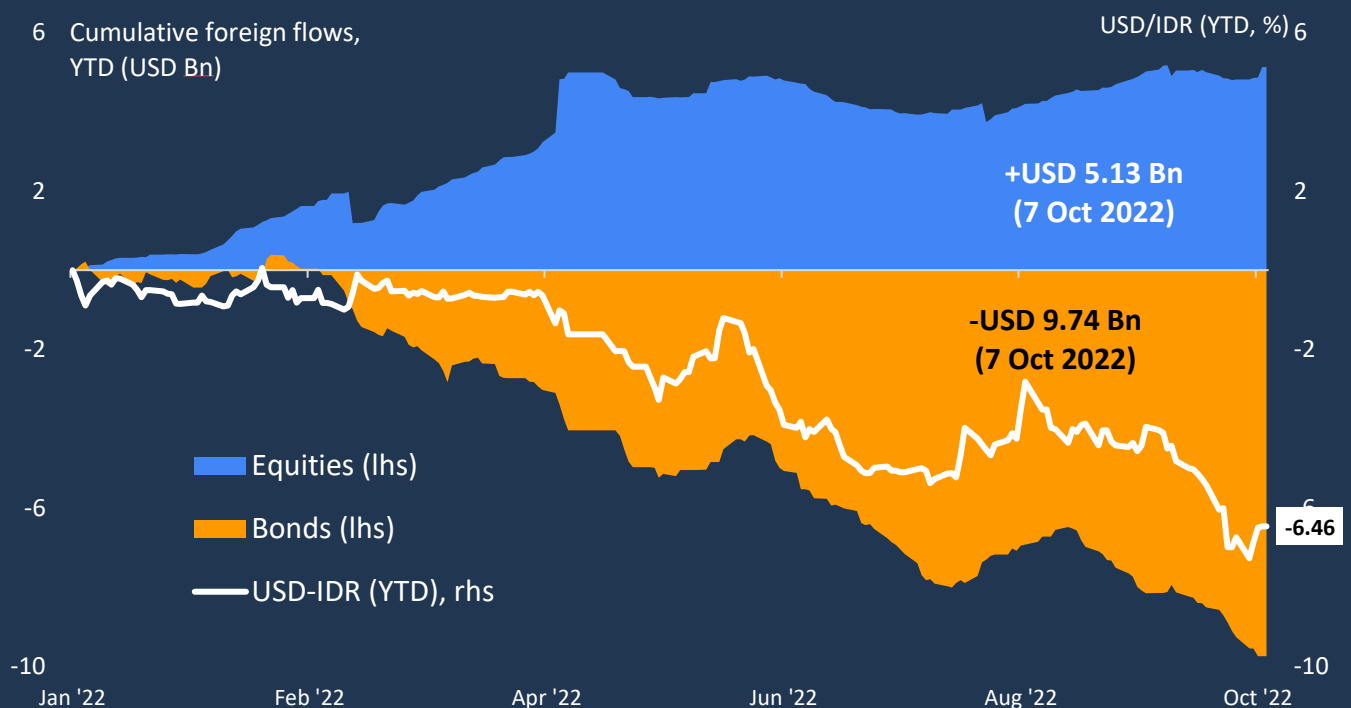
"BI's FX market intervention looks increasingly as a means of smoothing exchange rate fluctuations"

Chart 1. Worsening domestic FX liquidity condition may add pressure or the IDR to depreciate



Source: Bank Indonesia, Bloomberg
Data as of Sep-22 (Jul-22 for the FX liquidity index)

Chart 2. Higher domestic inflation and the prospect of widening the Fed – BI policy rate spread did little to curb capital outflows in the bond market



Source: Bloomberg, calculation by BCA economists

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	06-Oct	-1 mth	Chg (%)
US	3.25	Sep-22	-5.05	Baltic Dry Index	1,992.0	1,133.0	75.8
UK	2.25	Sep-22	-7.65	S&P GSCI Index	654.3	651.5	0.4
EU	1.25	Sep-22	-8.75	Oil (Brent, \$/bbl)	94.4	95.7	-1.4
Japan	-0.10	Jan-16	-3.10	Coal (\$/MT)	381.0	410.6	-7.2
China (lending)	4.35	Oct-15	1.85	Gas (\$/MMBtu)	6.92	8.97	-22.9
Korea	2.50	Aug-22	-3.10	Gold (\$/oz.)	1,712.5	1,710.4	0.1
India	5.90	Sep-22	-1.10	Copper (\$/MT)	7,649.8	7,731.0	-1.1
Indonesia	4.25	Sep-22	-1.70	Nickel (\$/MT)	22,666.5	21,424.0	5.8
Money Mkt Rates	06-Oct	-1 mth	Chg (bps)	CPO (\$/MT)	784.1	867.5	-9.6
				Rubber (\$/kg)	1.37	1.32	3.8
SPN (1M)	1.91	2.18	-26.8	External Sector	Aug	Jul	Chg (%)
SUN (10Y)	7.18	7.14	4.1	Export (\$ bn)	27.91	25.56	9.2
INDONIA (O/N, Rp)	3.84	3.24	59.4	Import (\$ bn)	22.15	21.35	3.8
JIBOR 1M (Rp)	4.89	4.08	80.8	Trade bal. (\$ bn)	5.76	4.22	36.5
Bank Rates (Rp)	Jun	May	Chg (bps)	Central bank reserves (\$ bn)*	130.8	132.2	-1.04
Lending (WC)	8.40	8.48	-7.13	Prompt Indicators	Aug	Jul	Jun
Deposit 1M	2.84	2.79	4.96	Consumer confidence index (CCI)	124.7	123.2	128.2
Savings	0.62	0.64	-1.17	Car sales (%YoY)	16.4	29.4	8.5
Currency/USD	06-Oct	-1 mth	Chg (%)	Motorcycle sales (%YoY)	11.6	-13.3	-30.9
UK Pound	0.896	0.868	-3.08	Cement sales (%YoY)	#N/A	#N/A	-41.1
Euro	1.021	1.007	-1.39				
Japanese Yen	145.1	140.6	-3.13				
Chinese RMB	7.116	6.934	-2.56				
Indonesia Rupiah	15,188	14,903	-1.88				
Capital Mkt	06-Oct	-1 mth	Chg (%)				
JCI	7,076.6	7,231.9	-2.15	Manufacturing PMI	Sep	Aug	Chg (bps)
DJIA	29,926.9	31,318.4	-4.44	USA	50.9	52.8	-190
FTSE	6,997.3	7,287.4	-3.98	Eurozone	48.4	49.6	-120
Nikkei 225	27,311.3	27,619.6	-1.12	Japan	50.8	51.5	-70
Hang Seng	18,012.2	19,225.7	-6.31	China	48.1	49.5	-140
Foreign portfolio ownership (Rp Tn)	Sep	Aug	Chg (Rp Tn)	Korea	47.3	47.6	-30
Stock	2,526.7	2,541.6	-14.84	Indonesia	53.7	51.7	200
Govt. Bond	730.3	759.5	-29.26				
Corp. Bond	15.5	15.2	0.24				

Source: Bloomberg, BI, BPS

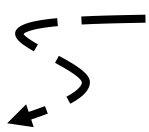
Notes:

^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

	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 the 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	45.5
Current Account Balance (% GDP)	-1.6	-3.0	-2.7	-0.4	0.3	1.4

** Estimation of the Rupiah's fundamental exchange rate

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