BI Policy:

More climbing necessary

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Executive Summary

- The BI7DRR climbed to 4.75% after the October meeting. The 50bps hike is widely expected given the IDR's lacklustre performance throughout the month.
- BI looks set to maintain its accommodative macroprudential policy to provide support for domestic consumption. This, however, may translate to less-productive capital allocation that could limit Indonesia's CA prospect.
- Short term considerations largely in favour for a more stable IDR as a weaker exchange rate wouldn't help to improve Indonesia's prospect.

- Bank Indonesia raised the BI7DRR by 50 bps during its October meeting, increasing the total rate hike in 2022 to 125 bps, essentially reverting to the pre-pandemic baseline of 4.75%. The decision to maintain the pace of policy rate hikes despite a downward correction to the central bank's inflation forecast is consistent with BI's strategy to deliver a front-loaded, pre-emptive, and forward-looking policy guideline to protect the domestic economy amidst proliferating external risks.

- Continued policy tightening by the Fed, which is expected to raise its policy rate by 75 bps at the upcoming FOMC meeting in November, clearly plays a role in BI's policy decision. The greenback has not shown any significant sign of weakness. At the same time, the anticipation of a higher Fed Funds Rate continues to increase yields on US-backed assets that continue to drain capital out of emerging markets. Indeed, the IDR has performed unconvincingly throughout October 2022, prompting BI to hike the policy rate by 50 bps in two consecutive meetings.

- Despite the increase in policy rates and the RRR, BI has not entirely abandoned its push for growth. Macroprudential policies, ranging from the LTV to the inclusive financing ratio (RPIM), continue to fuel demand for credits. Indeed, demand for lending is still growing vociferously after the first two rounds of BI's post-pandemic hike cycle, a strong sign for growth.

- However, this condition may complicate BI's effort to anchor inflation expectations back to the 2-4% target range coming Q3 next year ***(Chart 1)***. Fortunately, overall inflation has been tempered somewhat by the decline in food prices in recent months. Still, there is no guarantee that this will continue, especially if the intense precipitation (which has been a boon thus far) causes floods and logistical logjams down the road.

- All of this means that BI may start to ponder whether the economy would be hurt more by higher interest rates than a weaker IDR. The case for a stronger IDR, however, is certainly stronger in the short term. First, Indonesia's commodity-heavy exports basket stands little to benefit from a weaker IDR. A relatively weaker IDR would benefit the manufacturing sector, which is unlikely to boost exports anyway, considering the drying domestic demand and the already moribund global demand. A stable IDR is also imperative to limit the risk of imported inflation at the same time when the economy is still gearing up for the second-round inflationary effect of the increasing subsidised fuel prices.

- Over the long term, however, the benefit of having tighter control over the domestic financing condition is not insignificant. For one, extended relaxation of the LTV rule may channel more capital toward less productive undertakings. On the other hand, the RPIM incentive would direct more capital to the MSME sector, providing a boost to the previously (and arguably still) underserved sector. However, this policy comes at a time when BI seeks to drain liquidity in the banking system, which would reduce the domestic capital stock that may leave more productive sector behind. Indeed, loan growth YTD – up to July has been dominated by FX and SME loans, which altogether combine for about 46% of the increase in banks' loan portfolios this year. This is a rather unusual situation driven by rebounding imports on the one hand (for FX loans), and banks trying to meet the RPIM requirement on the other (for SME loans).

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- Both types of loans are undoubtedly necessary for post-pandemic recovery. Still, it also hints at upcoming pressures for Indonesia's current account balance (***Chart 2***), which has so far been one of its biggest buffers against the Dollar's relentless pressure. In particular, Indonesia's SMEs are not notably export-oriented – unlike, say, Germany's famous Mittelstand – and are often dominated by those in the trading sector, which tend to be importers. Suppose we add the 17% of loan portfolio growth that has come from consumer loans. In that case, we get the sense that the current situation – strong commodities, modest Rupiah depreciation (compared to peers) – could tend to push Indonesia further down the path of being pigeonholed as a commodity economy in the long-run, and this could be a problem if commodities further weaken as the global economy slips into recession.

- Minding all the basic calculus listed above, it's quite clear that short-term dynamics tend to favour a stable IDR. The profit of a stable IDR in the short term requires no further justification, while the benefit of a more conservative monetary policy setting would translate to more efficient capital allocation. Thus, further policy rate hikes to the tune of 50 bps before the end of the year seem like the most plausible scenario for now.

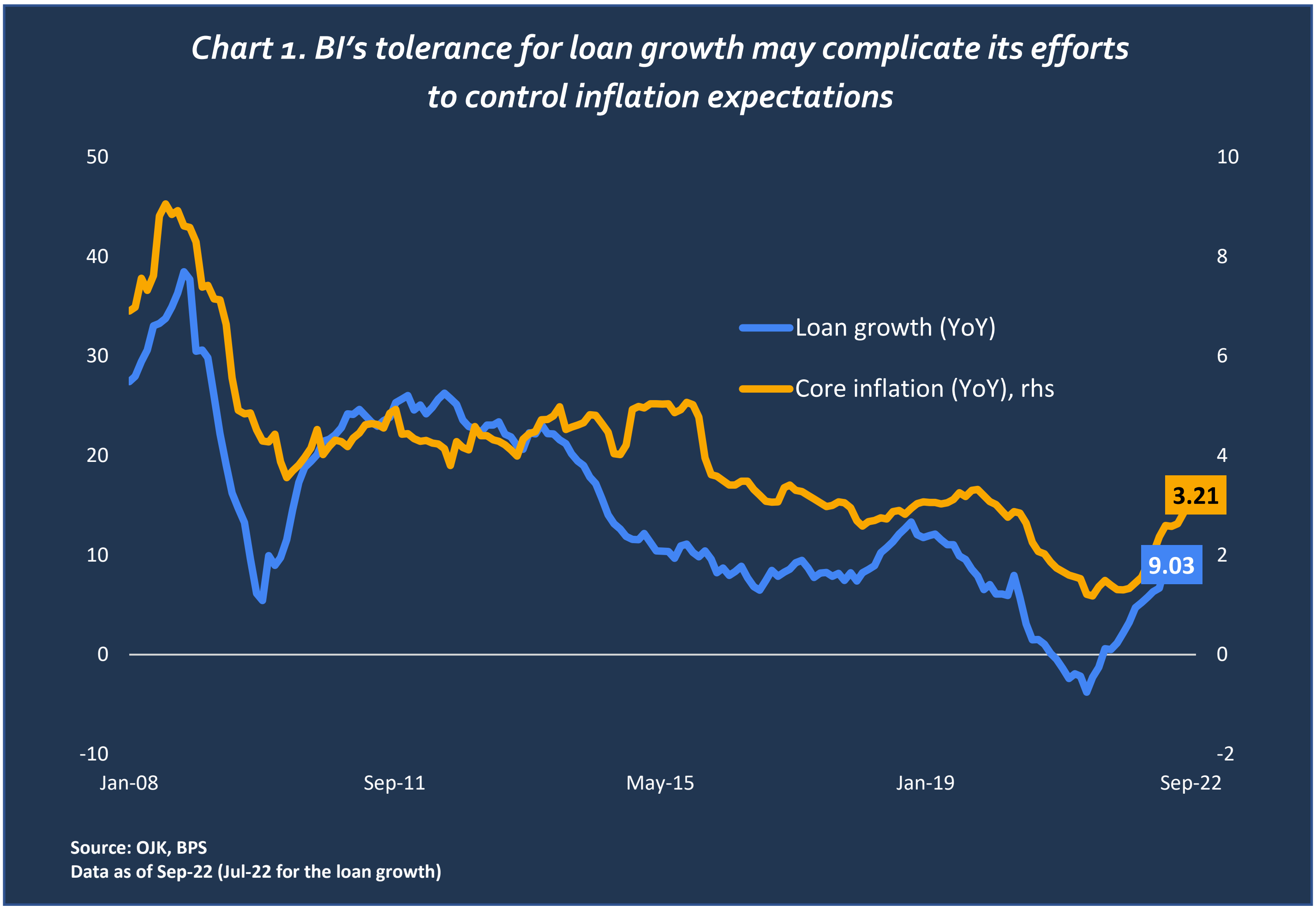
Chart 1. BI's tolerance for loan growth may complicate its efforts to control inflation expectations
50
40
30
20
10
0
-10
10
8
6
4
2
0
-2
Loan growth (YoY)
Core inflation (YoY), rhs
3.21
9.03
Jan-08
Sep-11
May-15
Jan-19
Sep-22
Source: OJK, BPS
Data as of Sep-22 (Jul-22 for the loan growth)

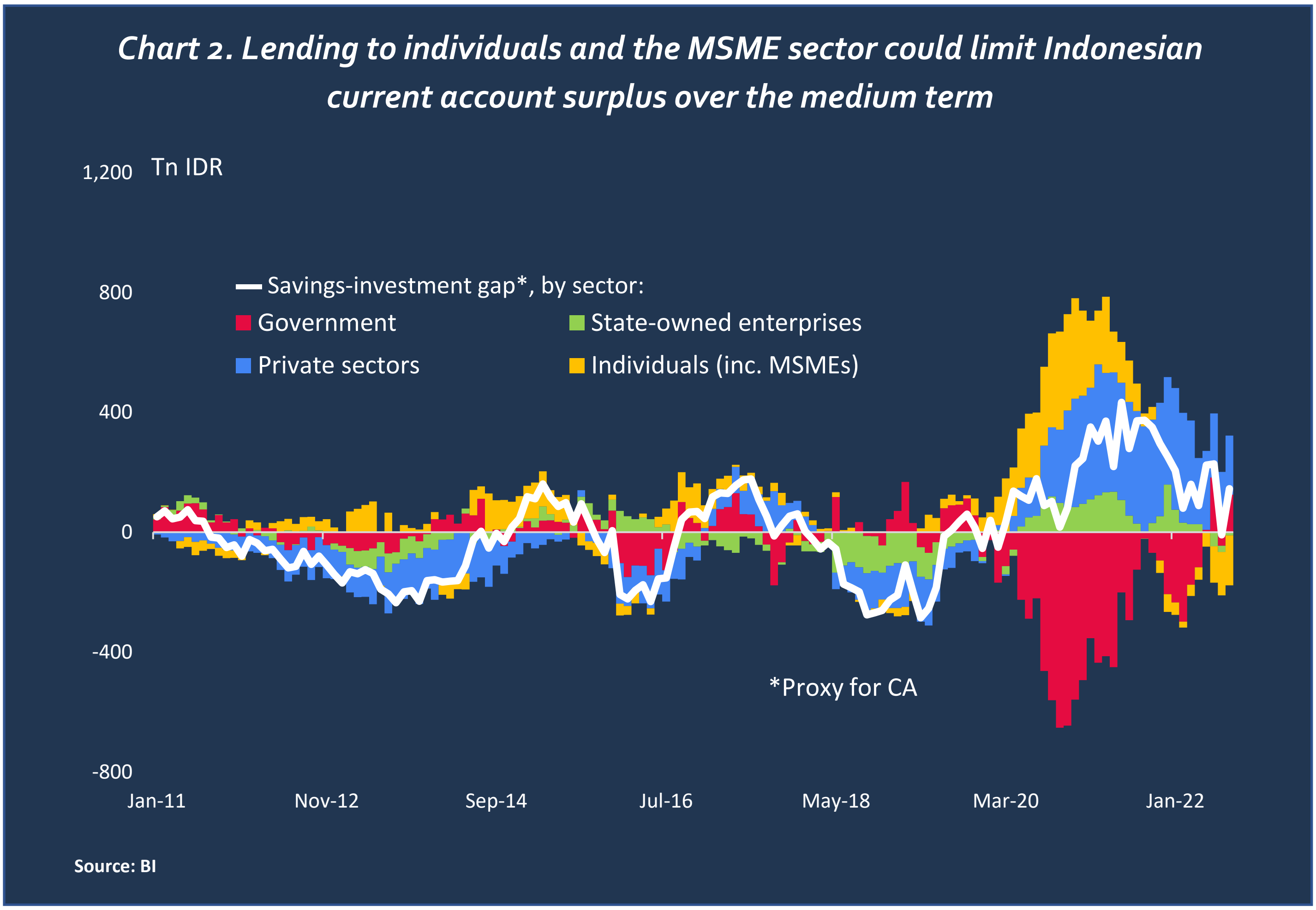
Chart 2. Lending to individuals and the MSME sector could limit Indonesian current account surplus over the medium term
1,200
Tn IDR
800
400
0
-400
-800
Savings-investment gap*, by sector:
Government
State-owned enterprises
Private sectors
Individuals (inc. MSMEs)
*Proxy for CA
Jan-11
Nov-12
Sep-14
Jul-16
May-18
Mar-20
Jan-22
Source: BI

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	3.25	Sep-22	-4.95
UK	2.25	Sep-22	-7.85
EU	1.25	Sep-22	-8.65
Japan	-0.10	Jan-16	-3.10
China (lending)	4.35	Oct-22	1.55
Korea	3.00	Oct-22	-2.60
India	5.90	Sep-22	-1.51
Indonesia	4.75	Oct-22	-1.20

Money Mkt Rates	19-Oct	-1 mth	Chg (bps)
SPN (1M)	2.56	1.99	57.8
SUN (10Y)	7.44	7.19	24.8
INDONIA (O/N, Rp)	3.82	3.30	52.9
JIBOR 1M (Rp)	4.94	4.28	65.9

Bank Rates (Rp)	Jun	May	Chg (bps)
Lending (WC)	8.40	8.48	-7.13
Deposit 1M	2.84	2.79	4.96
Savings	0.62	0.64	-1.17

Currency/USD	19-Oct	-1 mth	Chg (%)
UK Pound	0.891	0.876	-1.76
Euro	1.023	0.998	-2.43
Japanese Yen	149.9	142.9	-4.66
Chinese RMB	7.229	6.987	-3.34
Indonesia Rupiah	15,498	14,953	-3.52

Capital Mkt	19-Oct	-1 mth	Chg (%)
JCI	6,860.4	7,168.9	-4.30
DJIA	30,423.8	30,822.4	-1.29
FTSE	6,925.0	7,236.7	-4.31
Nikkei 225	27,257.4	27,567.7	-1.13
Hang Seng	16,511.3	18,761.7	-11.99

Foreign portfolio ownership (Rp Tn)	Sep	Aug	Chg (Rp Tn)
Stock	2,526.7	2,541.6	-14.84
Govt. Bond	730.3	759.5	-29.26
Corp. Bond	15.5	15.2	0.24

Trade & Commodities	19-Oct	-1 mth	Chg (%)
Baltic Dry Index	1,871.0	1,553.0	20.5
S&P GSCI Index	624.2	631.6	-1.2
Oil (Brent, $/brl)	92.4	91.4	1.2
Coal ($/MT)	393.3	423.5	-7.1
Gas ($/MMBtu)	5.92	8.00	-25.9
Gold ($/oz.)	1,629.4	1,675.1	-2.7
Copper ($/MT)	7,455.8	7,869.0	-5.3
Nickel ($/MT)	21,818.0	24,229.0	-10.0
CPO ($/MT)	846.7	814.6	3.9
Rubber ($/kg)	1.29	1.34	-3.7

External Sector	Sep	Aug	Chg (%)
Export ($ bn)	24.80	27.86	-11.0
Import ($ bn)	19.81	22.15	-10.6
Trade bal. ($ bn)	4.99	5.71	-12.6
Central bank reserves ($ bn)*	130.8	132.2	-1.06

Prompt Indicators	Sep	Aug	Jun
Consumer confidence index (CCI)	117.2	124.7	128.2
Car sales (%YoY)	18.9	16.4	8.5
Motorcycle sales (%YoY)	10.7	11.6	-30.9
Cement sales (%YoY)	#N/A	#N/A	-41.1

Manufacturing PMI	Sep	Aug	Chg (bps)
USA	50.9	52.8	-190
Eurozone	48.4	49.6	-120
Japan	50.8	51.5	-70
China	48.1	49.5	-140
Korea	47.3	47.6	-30
Indonesia	53.7	51.7	200

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$)	3877	3927	4175	3912	4350	4564
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	7.1
BI 7-day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	5.25
USD/IDR Exchange Rate (end of the year)**	13,433	14,390	13,866	14,050	14,262	15,293
Trade Balance (US$ 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	1.0

** Estimation of the Rupiah's fundamental exchange rate

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