FOMC:
A season of caution and compromise

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Executive Summary

- The Fed raised its target rate by 50 bps which sent the fed funds rate to the 4.25 – 4.50% range. FOMC members now see the terminal rate at around 5.1%, while the US economy is expected to narrowly avoid a recession scenario.
- Still-high inflation coupled with stable domestic financial and corporate sectors may encourage the Fed to continue hiking rates. But weakening demand and still-mercurial energy prices might complicate the Fed's effort to deliver on its tighter-for-longer outlook.
- We expect BI to hike towards 5.50% by year-end, with an additional 25-50 bps hike in 2023 to compensate for the IDR's weakening-but-still positive sentiment.

- The Federal Open Market Committee (FOMC) raised the fed funds rate by another 50 bps, bringing the policy rate to the range of 4.25 – 4.50% which brings rate hikes throughout 2022 to a total of 425 bps. The season-ending FOMC meeting also comes with updated economic projections, which signals more rate hikes coming in 2023 as a majority of FOMC members are now looking at somewhere around 5.25% as the terminal rate in the current tightening campaign, up from around 4.6% that the committee projected in September 2022.

- The FOMC also downplays the prospect of a 'Fed pivot' in 2023, signalling that the policy rate would remain considerably restrictive for an extended period which echoes its expectation of rather sticky inflation. Equally notable is the adjustment in the US economic growth projection, with the economy now expected to grow by 0.5% in 2023, down from 1.2% previously. The new forecast still illustrates the Fed's optimism in delivering a soft-landing scenario, albeit with considerable pain, as illustrated in the upward revision to the FOMC's median expectation of the unemployment rate.

- The Fed's decision to slow its tightening campaign by a notch is hardly news. But the central bank's still-hawkish outlook may surprise some in the market. Indeed, many in the market have been vigilant of signs of a weakening US economy, hoping that such a development would encourage the Fed to change its bearing. The lower-than-expected CPI figure in November, which portends a widespread slowdown in consumption, strengthened the market's confidence that the Fed would stop its tightening campaign before it breaches the 5% Highmark. This, however, may not be the case as the Fed seems set to double down on its effort to yank inflation back to the target level.

- Weakening demand is a worrying sign, especially for a consumer-driven economy such as the US. There's also an issue with the structure of the US labour market. Indeed, large number of jobs gained throughout the post-pandemic months have been in lower-skilled occupations, which is quite susceptible to a drop in economic confidence considering its more cyclical nature. It would be crucial for the Fed, then, to safeguard demand, especially in the still-cheerful service sector. Alas, the Fed's monetary-side arsenal may not provide the booster needed to push the economy out of the gravitational pull of worsening confidence, as interest rates at 3 or 4% would hardly encourage people to spend.

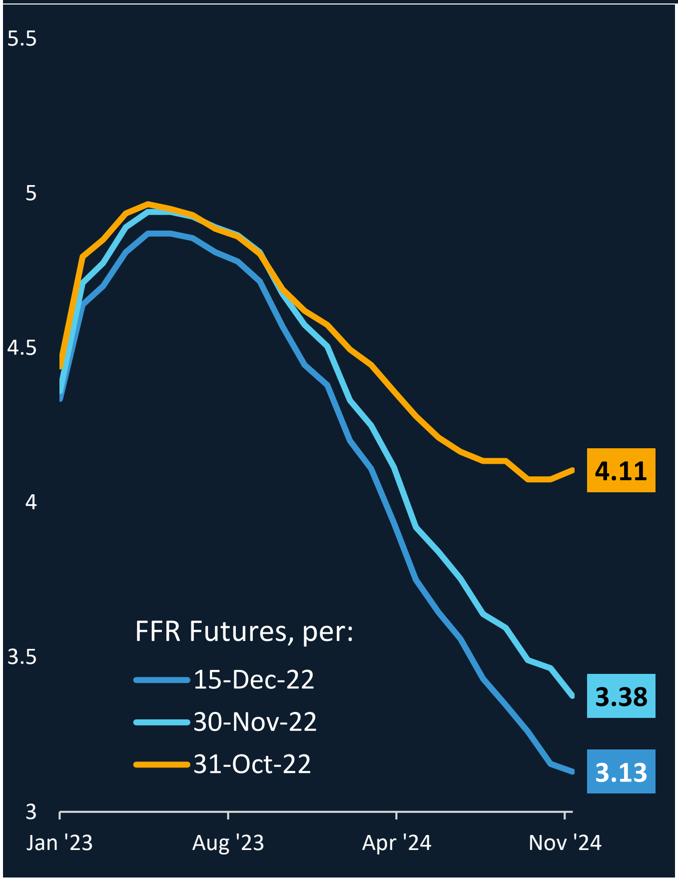
- At the same time, the Fed is still fighting its old nemesis – the weakening-yet-still-lofty inflation. Indeed, a stable domestic financial and corporate sector provides the avenue through which the Fed could continue to hike rates. But higher rates would also stymie shale producers, which could translate to another upward swing in energy prices, especially when the US government comes back to the market to fill the SPR. The Fed is indeed facing an impasse, it may have headed to the water but it remains unclear whether or not the central bank could cross its Rubicon. The decision to revert to a more gradual hike in 2023 may signal the Fed's readiness to work on a compromise; increasing the policy rate more steadily would help the Fed to find the optimal (minimum) level where the real rate of return would tip back to positive, avoiding the risk of over-tightening.

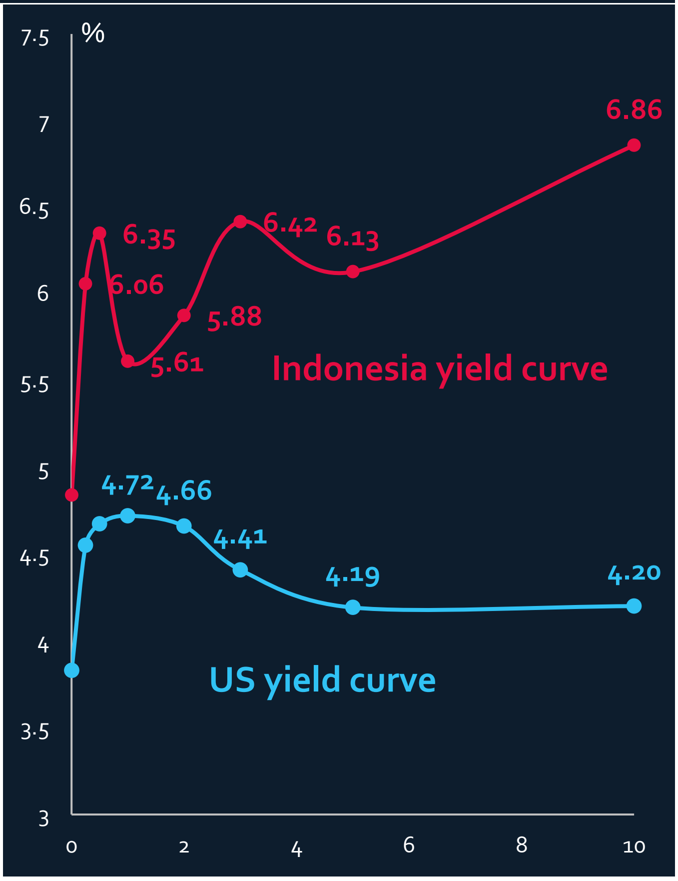
> ***"Higher rates would stymie energy producers, which could translate to another upswing in energy prices (and inflation)"***

- The Fed's softening hike trajectory had deflated some of the USD's muscle, but its rather hawkish talks may halt further depreciation in the USD value. Many central banks, then, is still under the urgency to tighten. Indeed, in an announcement scheduled later this day, the ECB and the BoE are expected to hike their policy rate by 50 bps, while the Swiss National Bank already increased its policy rate by 50 bps to 1.00%. A tighter policy rate would be crucial for these European (and many others) central banks to limit the downward pressure against their currencies amid the still-dominating USD. Alas, such a policy call would also prolong the winter of economic (and political) discontent that now brewing in Europe.

- In contrast, Bank Indonesia will reconvene next week for its final meeting of the year against a more colourful backdrop. The IDR's value has stabilised throughout December, courtesy of favourable development in the global commodity market that allows the Indonesian economy to maintain its outsized trade surplus. Foreign capital starts to flow back to the Indonesian bond market but the still meagre foreign ownership would insulate the IDR from the full brunt of the Fed's hawkish talks. However, as we previously noted, the slowly-normalising coal prices coupled with a more neutral CA next year may continue to gnaw at the IDR's value. BI, then, may look to hike the BI 7DRR by 25 bps in the upcoming meeting, ending the year at 5.50%. We expect BI's rate hike cycle to finally cease in early 2023, but further 25-50 bps hike after the New Year are still not impossible at this point.

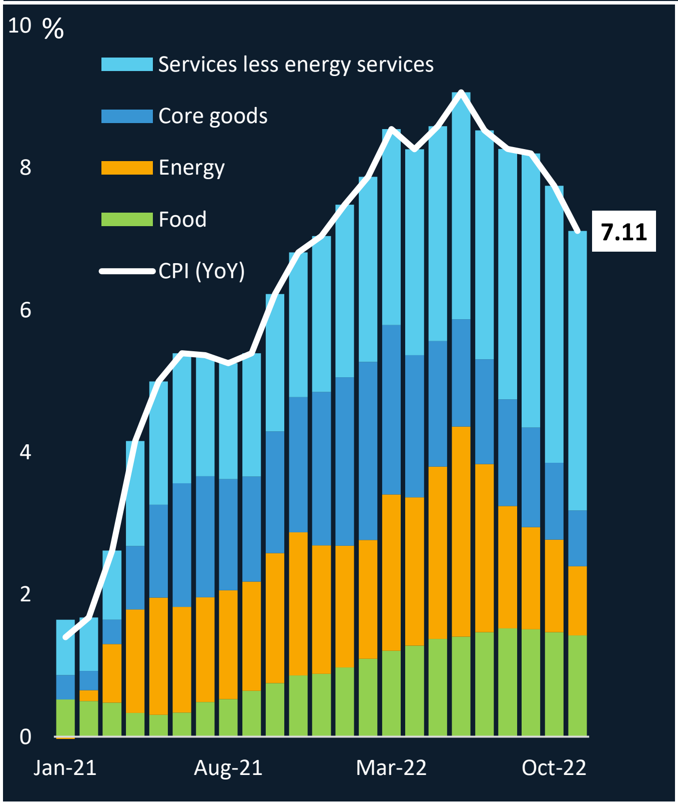
Panel 1. Fed hikes are expected to continue into 2023, but Indonesia maintains healthy nominal yield spreads versus the US especially in the longer end

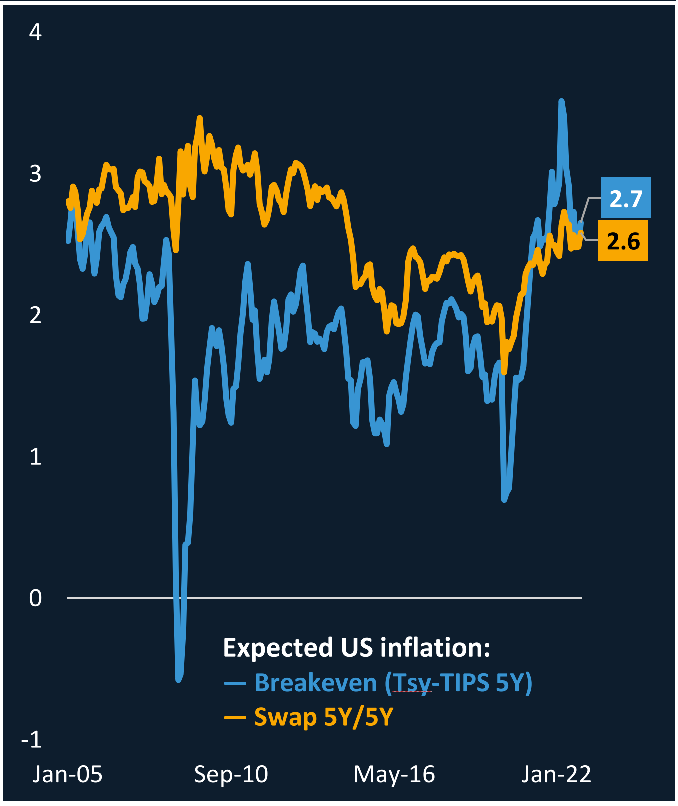




Source: Bloomberg, BI

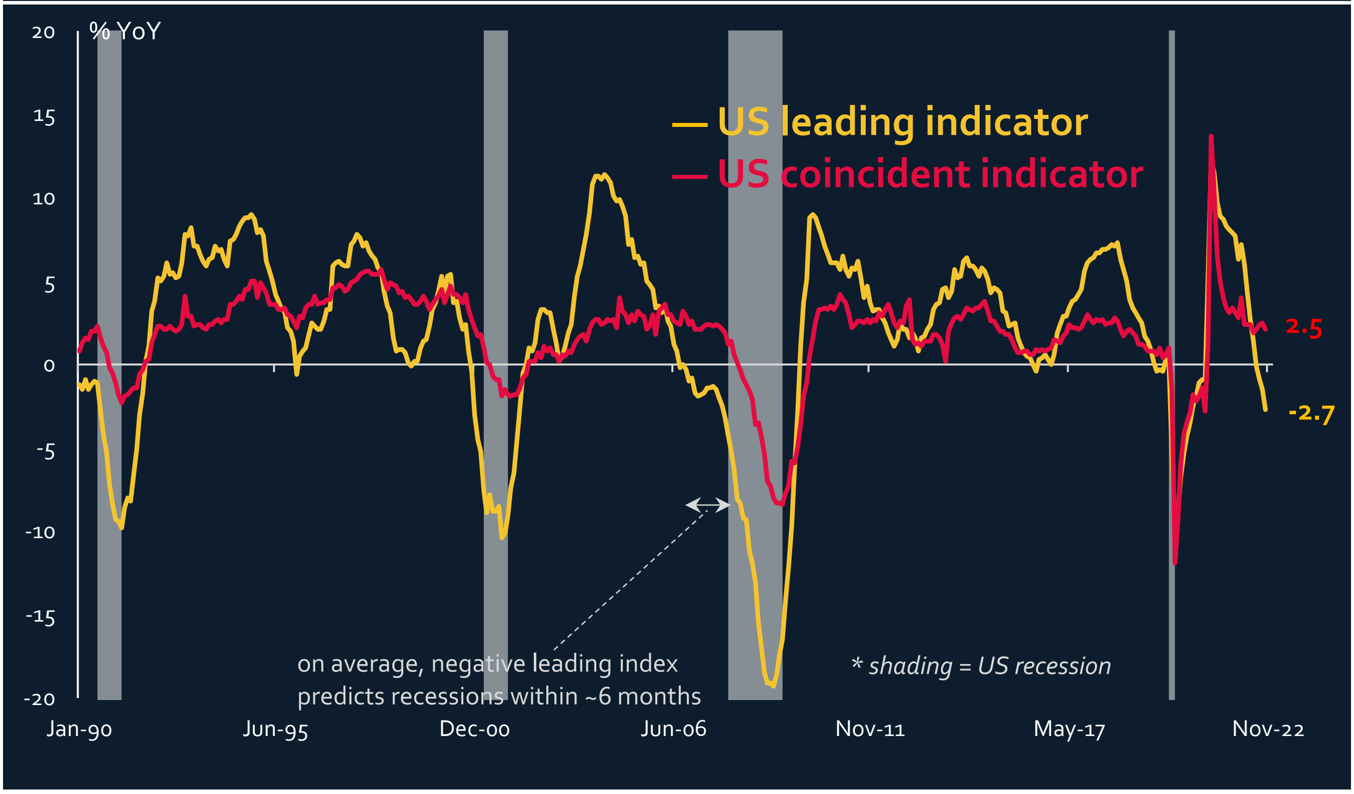
Panel 2. The long-run expectation of US inflation remains well-anchored but the inflation expectation remains stubbornly high due to some sticky components





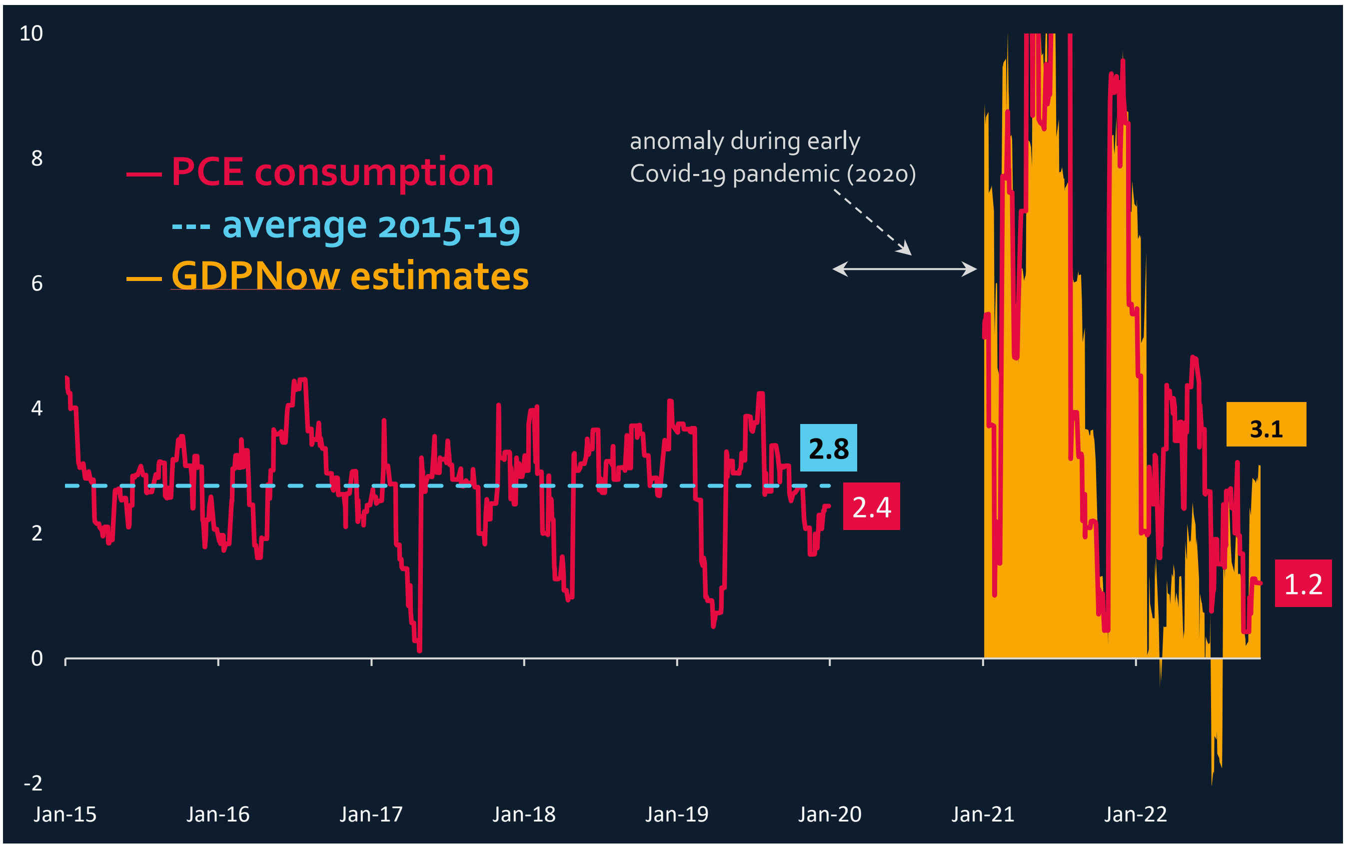
Source: US BLS, Bloomberg

Chart 1. **The FOMC still expects a soft-landing scenario, but the spectre of recession has become more apparent**



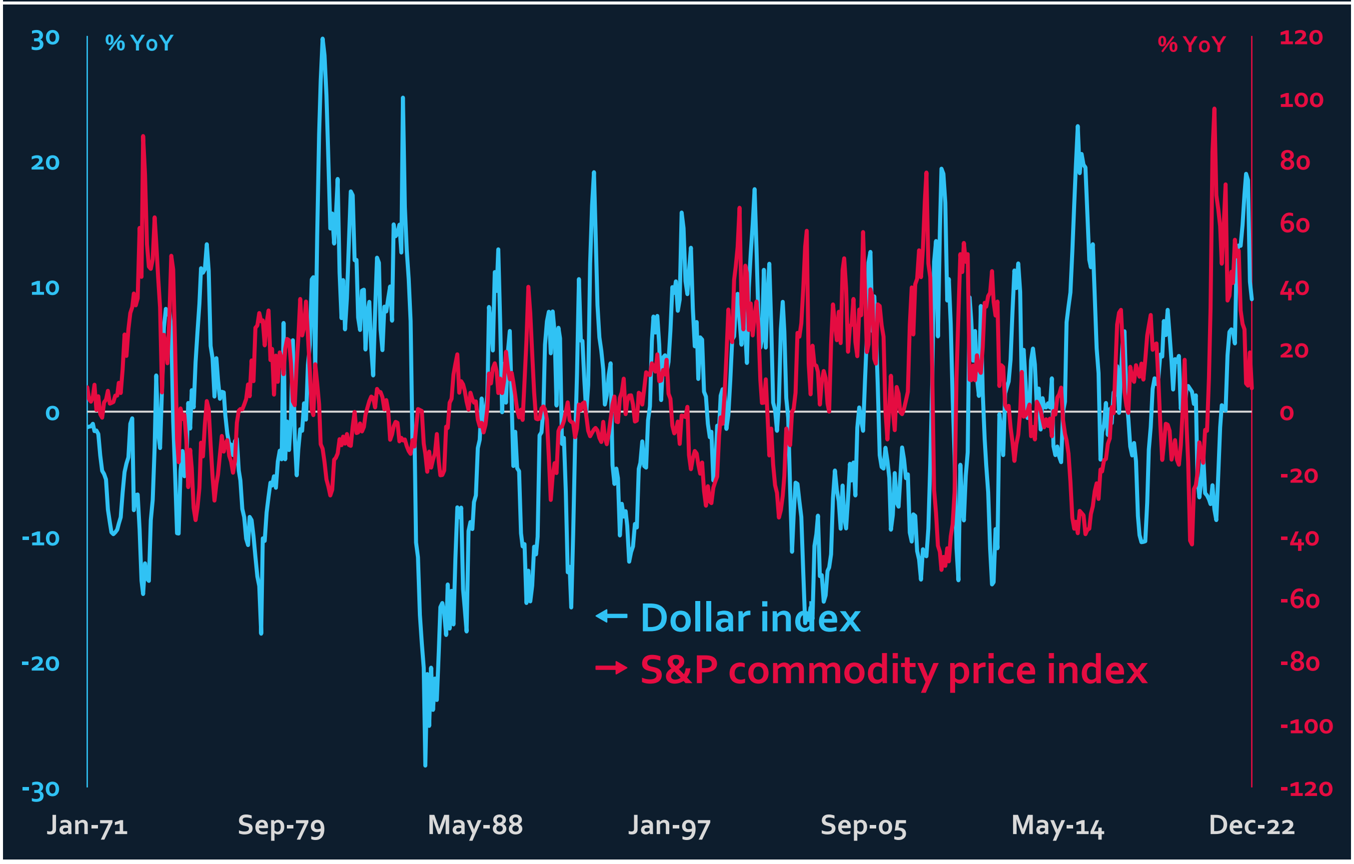
Source: Bloomberg

Chart 2. **GDP nowcast points to slowing demand amidst strong GDP print**



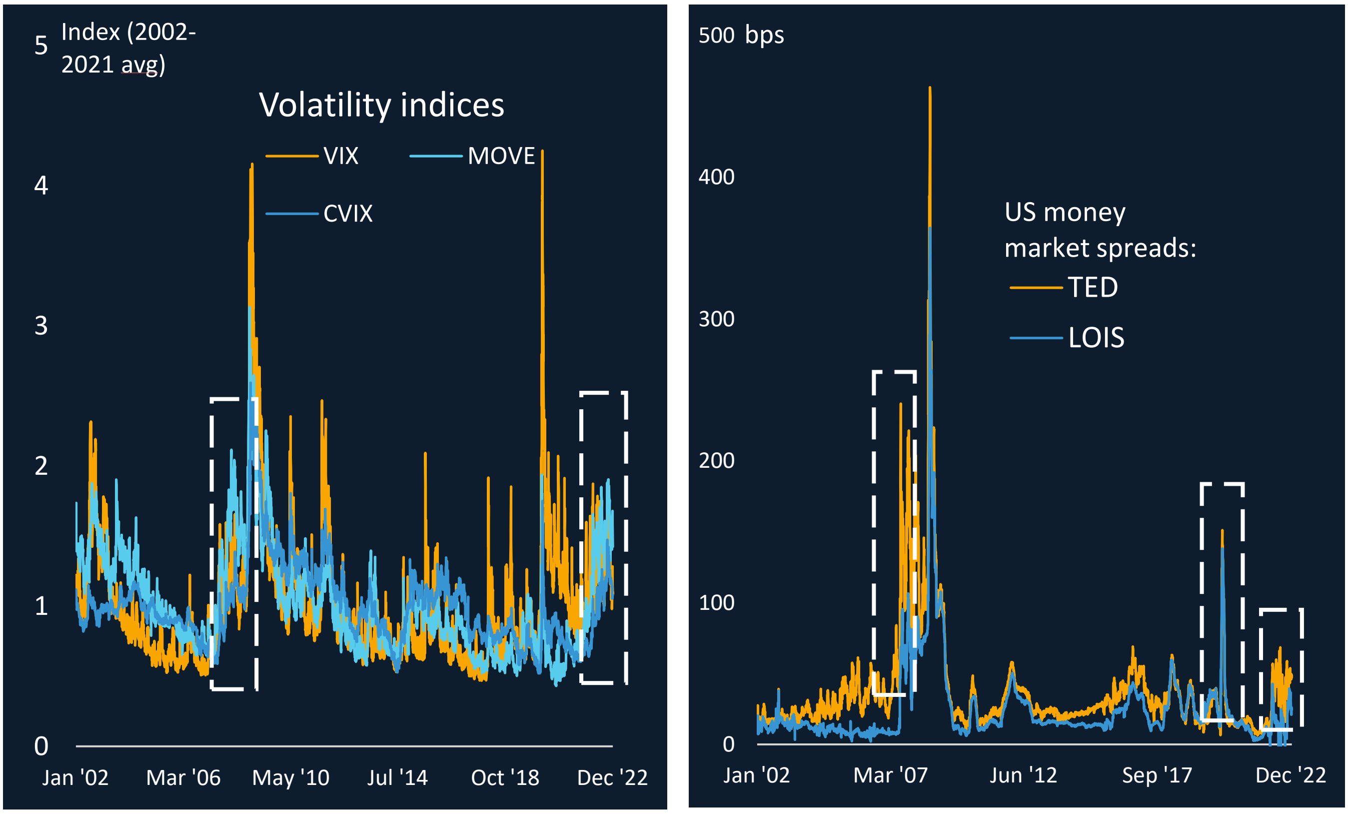
Source: Atlanta Fed

Chart 3. Weakening demand has lowered commodity prices but a strong USD might still be needed to suppress prices even more



Source: Bloomberg

Panel 3. Stress has risen in Treasury and FX markets while the US money market stays quiescent



Source: Bloomberg

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	4.00	Nov-22	-3.10
UK	3.00	Nov-22	-7.70
EU	2.00	Nov-22	-8.00
Japan	-0.10	Jan-16	-3.80
China (lending)	4.35	Nov-22	2.75
Korea	3.25	Nov-22	-1.75
India	6.25	Dec-22	0.37
Indonesia	5.25	Nov-22	-0.17

Money Mkt Rates	14-Dec	-1 mth	Chg (bps)
SPN (1M)	3.39	5.19	-180.0
SUN (10Y)	6.86	7.04	-18.4
INDONIA (O/N, Rp)	4.84	4.31	52.9
JIBOR 1M (Rp)	5.95	5.45	50.0

Bank Rates (Rp)	Aug	Jul	Chg (bps)
Lending (WC)	8.42	8.42	-0.03
Deposit 1M	2.87	2.83	3.57
Savings	0.65	0.64	0.98

Currency/USD	14-Dec	-1 mth	Chg (%)
UK Pound	0.805	0.845	5.04
Euro	0.936	0.966	3.24
Japanese Yen	135.5	138.8	2.46
Chinese RMB	6.950	7.097	2.12
Indonesia Rupiah	15,598	15,494	-0.67

Capital Mkt	14-Dec	-1 mth	Chg (%)
JCI	6,801.7	7,089.2	-4.05
DJIA	33,966.4	33,747.9	0.65
FTSE	7,495.9	7,318.0	2.43
Nikkei 225	28,156.2	28,263.6	-0.38
Hang Seng	19,673.5	17,325.7	13.55

Foreign portfolio ownership (Rp Tn)	Nov	Oct	Chg (Rp Tn)
Stock	2,656.0	2,630.5	25.56
Govt. Bond	736.9	713.2	23.70
Corp. Bond	14.5	15.4	-0.86

Trade & Commodities	14-Dec	-1 mth	Chg (%)
Baltic Dry Index	1,401.0	1,355.0	3.4
S&P GSCI Index	602.9	646.7	-6.8
Oil (Brent, $/brl)	82.7	96.0	-13.8
Coal ($/MT)	363.2	291.5	24.6
Gas ($/MMBtu)	6.60	4.74	39.2
Gold ($/oz.)	1,807.3	1,771.2	2.0
Copper ($/MT)	8,478.3	8,501.9	-0.3
Nickel ($/MT)	28,143.0	26,856.0	4.8
CPO ($/MT)	885.3	902.3	-1.9
Rubber ($/kg)	1.37	1.27	7.9

External Sector	Nov	Oct	Chg (%)
Export ($ bn)	24.12	24.73	-2.5
Import ($ bn)	18.96	19.14	-0.9
Trade bal. ($ bn)	5.16	5.59	-7.8
Central bank reserves ($ bn)*	134.0	130.2	2.92

Prompt Indicators	Nov	Oct	Aug
Consumer confidence index (CCI)	119.1	120.3	124.7
Car sales (%YoY)	4.2	23.3	16.4
Motorcycle sales (%YoY)	26.9	20.9	11.6

Manufacturing PMI	Nov	Oct	Chg (bps)
USA	49.0	50.2	-120
Eurozone	47.1	46.4	70
Japan	49.0	50.7	-170
China	49.4	49.2	20
Korea	49.0	48.2	80
Indonesia	50.3	51.8	-150

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	5.3
GDP per Capita (US$)	3877	3927	4175	3912	4350	4564
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	5.6
BI 7 day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	5.5
USD/IDR Exchange Rate (end of year)**	13,433	14,390	13,866	14,050	14,262	15,584
Trade Balance (US$ billion)	11.8	-8.5	-3.2	21.7	35.3	52.8
Current Account Balance (% GDP)	-1.6	-3.0	-2.7	-0.4	0.3	0.9

** Estimation of Rupiah's fundamental exchange rate

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