Do not fear the widening rate differential

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Lazuardin Thariq Hamzah
lazuardin_hamzah@bca.co.id

Barra Kukuh Mamia
barra_mamia@bca.co.id

Summary

- More aggressive tightening campaigns in Europe could weaken the DXY going forward, but the USD may still strengthen against non-core Asian currencies considering Asian central banks' reluctance to match the Fed or European central banks' tightening pace.
- Widening rate differentials are consistent with Asian central banks' growth-friendly outlook as a weaker currency may add to Asian countries' competitiveness in the export market while also helping to trap aggregate demand inside the domestic economy.
- Still-high coal prices coupled with better FX liquidity conditions in the domestic economy would help BI to stabilise the Rupiah's value despite the widening rate differential between Rupiah-denominated and safe haven assets.

- Last week is a bad one for the doves. FOMC members may have agreed unanimously to hike the federal funds rate by only 25bps in the February meeting, signalling an end to the Fed's tightening campaign perhaps by the end of Q1 2023. But minutes from that meeting show that some FOMC members are more open (or at least, could be persuaded) to the idea of a 50bps hike. The Fed's favourite inflation gauge, the core PCE number, also runs higher than expectation – clocking at 0.6% YoY for January 2023 rather than 0.3 – 0.4% YoY projected by the market. The still-hot PCE number is not too surprising given the rebound in the US personal spending data (1.8% YoY in Jan-23, -0.1% YoY previously). **Fed Chairman Jerome Powell likes to say that monetary policy should be data-dependent, and the data suggest that the Fed is en route to a 5.25% terminal rate *(see Chart 1)***.
- What happened afterwards is a continuation of previous events: commodity prices (especially for industrial metals) sliding downward and investors retreating (in an orderly manner) towards the exit from riskier markets, courtesy of the rebounding USD's value. However, the USD, or at least the DXY, may not be as strong for too long. The Fed may still be on a hiking trail, but European central banks (mainly the ECB but also the BoE and Swiss National Bank) look set to be more aggressive in raising interest rates this year. The BoJ is also about to introduce a new helmsman, one that is not known for his dovish (or hawkish) tendency. Narrowing policy rate differentials may lower the USD's value against these core currencies, hence

the lower DXY. However, the picture may look somewhat different, especially for emerging currencies.

- Central banks in Asia, it appears, are more reluctant to hike their policy rate following the Fed's tightening campaign ***(see Chart 2).*** The PBoC's continued monetary expansion is the bigger story, but BI's decision to stop hiking interest rates is also rather momentous. Last week, the Bank of Korea (BoK) also put an end to its tightening campaign, citing downside risks to the economy and the grim prospect of financial instability as a reason to settle its policy rate after "only" a 225bps hike.

"A weaker currency might trap consumer demand inside the domestic economy, a boost to Indonesia's still under-utilised industrial capacity"

- The BoK may still be the only central bank that explicitly mentions the risk of domestic economic slowdown as a reason to stop tightening monetary policy. But this vigilance may also be shared by other Asian economies. The concern regarding the prospect of economic malaise in Asia is rather clear if we look at the stuff that Asian economies sell in the global market. The first one, and the more relevant one for Asian economies such as South Korea and Vietnam is manufactured products. This economic model, of course, will benefit from the still-resilient consumption level in the US and Europe.

- But such a model may also put Asia's many manufacturing hubs in direct competition with China. China, of course, holds the cost advantage – courtesy of the decade-long practice of economies of scale (which borders an oversupply problem) and the widening rate differentials that put depreciation pressure on the CNY. Indeed, **this is one of the cases where China's re-opening may absorb the growth potential of its neighbours, forcing other economies to react.**

- Other stuff that Asian economies sell, this one more relevant for the Indonesian economy, are commodities. The commodity supercycle last year, of course, had redistributed growth from consumers in the North (excl. Russia) to commodity producers in the South (including Indonesia). Alas, commodity prices had weakened quite expeditiously in the opening weeks of 2023, suppressing the contribution of exports to the prospects for economic growth in commodity-producing countries.

- Lower net exports coupled with the prospect of widening policy rate differential, of course, could depress the IDR's value – and some may argue that such a situation warrants BI to continue hiking the BI 7DRR. Considering the developing situation, however, we maintain our view that BI's decision to settle at 5.75% is rather justified. For one, **a weaker Rupiah may trap Indonesian consumers' demand in the domestic economy, giving a hand to the domestic manufacturing sector.** Such a condition may also help to recover

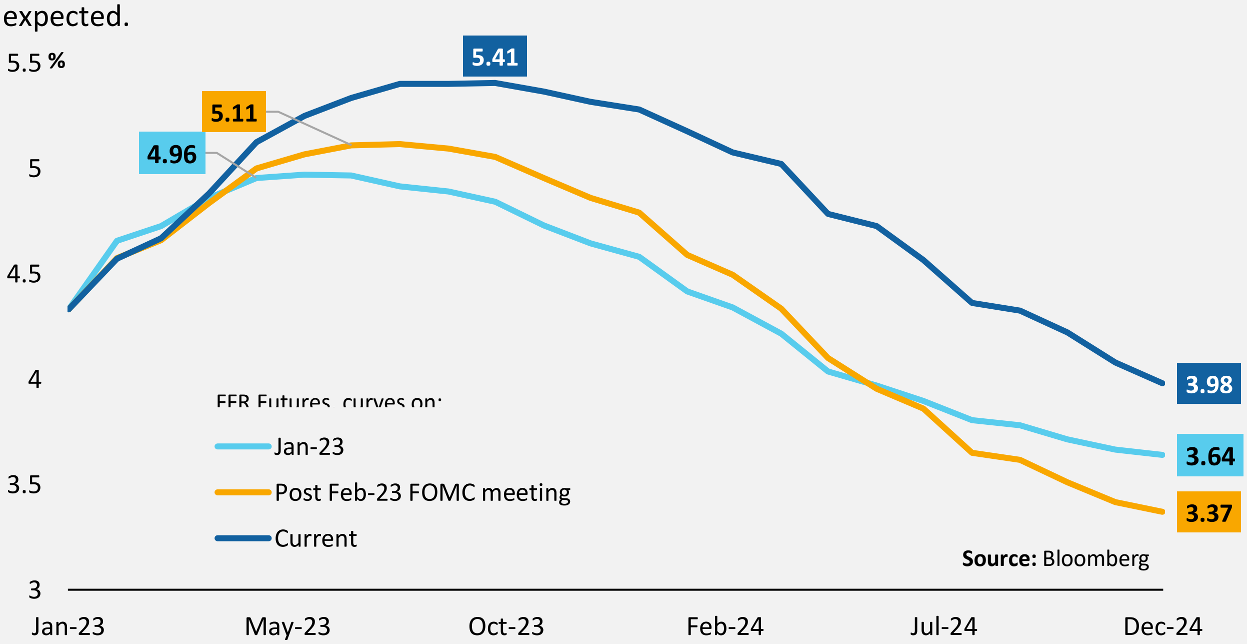
Indonesia's still-suppressed industrial utilisation rate **(*see* Chart 3)**, allowing domestic manufacturers to operate closer to scale.

- It appears then that BI, and a score of other Asian central banks, is comfortable trading exchange rate stability for growth. However, we have to consider that imported raw materials and intermediate goods are an indispensable part of Asia's manufacturing supply chain – which is truer for emerging industrial countries such as Indonesia or Vietnam which are still dependent on imported machinery. Having a weaker currency may eliminate the one insurance that the oil-importing part of Asia has to mitigate the still-uncertain outlook in the global oil market.
- Fortunately for the Indonesian economy**, the narrowing rate differential does not mean that BI is leaving the Rupiah unprotected.** After all, prices of mainstay export products such as coal remain considerably high compared to its historical average, and the rejuvenated export proceeds (DHE) policy would guarantee a better circulation of FX liquidity in the domestic economy. A weakening Rupiah, probably to the level around 15,500 – 15,600/USD may be hard to avoid, but such a condition may turn out to be the most optimum setting for the Indonesian economy.

Chart 1

Doves cannot fly this high

Many in the market expect the Fed to hike the FFR by at least 25bps in the next three FOMC meetings, ending the tightening campaign later with a much higher terminal rate than previously expected.



Source: Bloomberg

Chart 2

Asian reluctance

Asian central banks tend to be less aggressive in hiking rates due to relatively muted inflationary pressures and the prospect of domestic economic slowdowns amid China's re-opening.

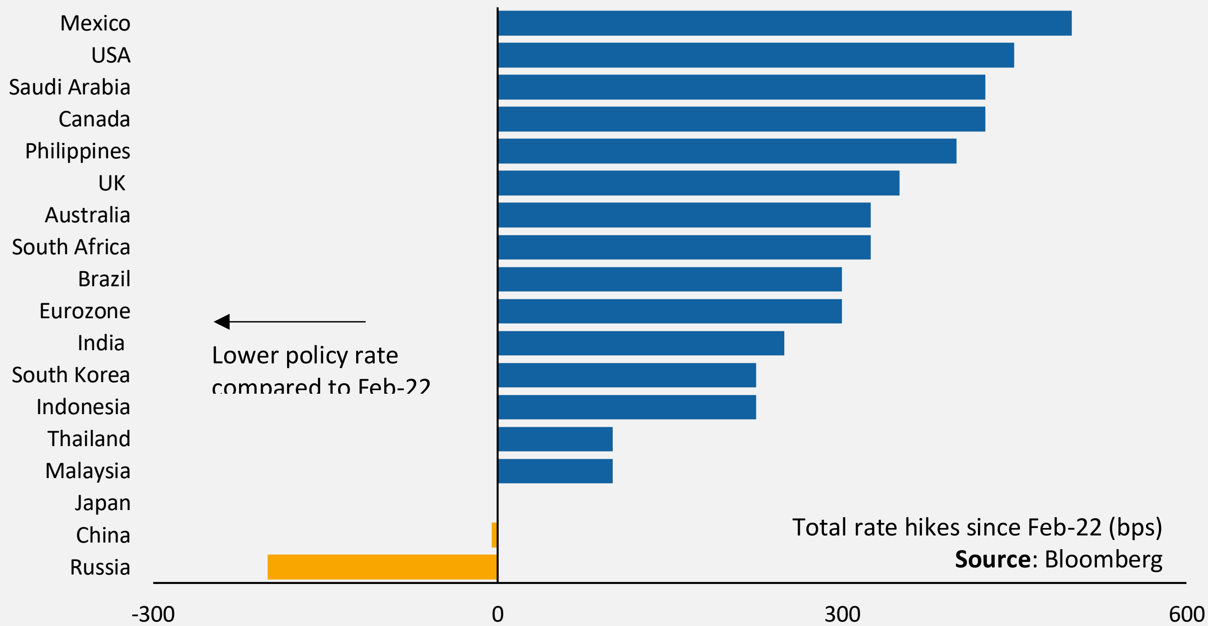


Chart 3

Rooms to optimise

A weaker currency may suppress demand for imported goods, which may encourage activities in the domestic manufacturing sector if those demands shifted to domestically-produced goods.

Economic Calendar

		Actual	Previous	Forecast*
1 February 2023				
ID	Manufacturing PMI	**51.3**	50.9	50.8
ID	**CPI Inflation YoY**	**5.28%**	5.51%	5.43%
2 February 2023				
US	**Fed rate decision**	**4.75%**	4.50%	4.75%
EU	ECB deposit rate decision	**2.50%**	2.00%	2.50%
3 February 2023				
US	Non-farm payrolls (thousands)	**517**	260	185
US	Unemployment rate	**3.4%**	3.5%	3.6%
6 February 2023				
ID	**GDP Growth Q4 2022 (YoY)**	**5.01%**	**5.72%**	**4.8%**
7 February 2023				
ID	**Foreign exchange reserve (USD Bn)**	**139.4**	**137.2**	**138.0**
US	Balance of trade (USD Bn)	-67.4	-61.5	-68.8
8 February 2023				
ID	Consumer confidence index	123.0	119.9	120
9 February 2023				
ID	Retail sales (YoY)	0.7%	1.3%	3.0%
US	Initial jobless claims	196K	183K	189.0K
10 February 2023				
CN	Inflation rate YoY	2.1	1.8	2
14 February 2023				
US	CPI Inflation YoY	6.4%	6.5%	6.3%
15 February				
ID	**Balance of trade (USD Bn)**	**3.87**	**3.89**	**3.1**
US	Retail sales YoY	6.4%	6%	4.5%
16 February				
CN	House price index YoY	-1.5%	-1.5%	-1.3
US	PPI YoY	6%	6.2%	6.0%
ID	**BI 7DRR decision**	5.75%	5.75%	6.00%
20 February				
ID	**Current account Q4 2022 (USD Bn)**	**4.3**	**4.4**	**3.5**
23 February				
EU	Inflation rate YoY	8.6	9.2	8.5
ID	Property price index Q4 2022 (YoY)	2.00%	1.94%	

*Forecasts of some indicators are simply based on market consensus
Bold indicates indicators covered by the BCA Monthly Economic Briefing report

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	4.75	Feb-23	-1.65
UK	4.00	Feb-23	-6.10
EU	3.00	Feb-23	-5.60
Japan	-0.10	Jan-16	-4.40
China (lending)	4.35	Feb-23	2.25
Korea	3.50	Feb-23	-1.70
India	6.50	Feb-23	-0.02
Indonesia	5.75	Feb-23	0.47

Money Mkt Rates	24-Feb	-1 mth	Chg (bps)
SPN (1M)	4.45	4.30	14.9
SUN (10Y)	6.78	6.61	17.6
INDONIA (O/N, Rp)	5.50	5.23	26.9
JIBOR 1M (Rp)	6.39	6.43	-3.7

Bank Rates (Rp)	Nov	Oct	Chg (bps)
Lending (WC)	8.60	8.58	1.67
Deposit 1M	3.69	3.36	32.89
Savings	0.67	0.67	0.00

Currency/USD	24-Feb	-1 mth	Chg (%)
UK Pound	0.837	0.811	-3.16
Euro	0.948	0.919	-3.11
Japanese Yen	136.5	130.2	-4.62
Chinese RMB	6.960	6.785	-2.52
Indonesia Rupiah	15,225	14,888	-2.21

Capital Mkt	24-Feb	-1 mth	Chg (%)
JCI	6,856.6	6,860.9	-0.06
DJIA	32,816.9	33,734.0	-2.72
FTSE	7,878.7	7,757.4	1.56
Nikkei 225	27,453.5	27,299.2	0.57
Hang Seng	20,010.0	22,044.7	-9.23

Foreign portfolio ownership (Rp Tn)	Jan	Dec	Chg (Rp Tn)
Stock	2,700.6	2,699.4	1.22
Govt. Bond	811.9	762.2	49.70
Corp. Bond	12.4	12.5	-0.02

Trade & Commodities	24-Feb	-1 mth	Chg (%)
Baltic Dry Index	883.0	721.0	22.5
S&P GSCI Index	577.6	612.2	-5.7
Oil (Brent, $/brl)	83.2	86.1	-3.4
Coal ($/MT)	205.8	267.8	-23.1
Gas ($/MMBtu)	2.36	3.35	-29.6
Gold ($/oz.)	1,811.0	1,937.4	-6.5
Copper ($/MT)	8,689.0	9,291.0	-6.5
Nickel ($/MT)	24,340.5	28,561.0	-14.8
CPO ($/MT)	930.6	914.3	1.8
Rubber ($/kg)	1.38	1.42	-2.8

External Sector	Jan	Dec	Chg (%)
Export ($ bn)	22.31	23.83	-6.36
Import ($ bn)	18.44	19.86	-7.15
Trade bal. ($ bn)	3.87	3.97	-2.39
Central bank reserves ($ bn)*	139.4	137.2	1.58

Prompt Indicators	Jan	Dec	Nov
Consumer confidence index (CCI)	123.0	119.9	119.1
Car sales (%YoY)	11.8	9.0	4.4
Motorcycle sales (%YoY)	38.6	24.6	26.9

Manufacturing PMI	Jan	Dec	Chg (bps)
USA	47.4	48.4	-100
Eurozone	48.8	47.8	100
Japan	48.9	48.9	0
China	49.2	49.0	20
Korea	48.5	48.2	30
Indonesia	51.3	50.9	40

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

Indonesia – Economic Indicators Projection

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	4.7
GDP per Capita (US$)	3927	4175	3912	4350	4784	5011
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	4.3
BI 7-day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	5.75
USD/IDR Exchange Rate (end of the year)**	14,390	13,866	14,050	14,262	15,568	15,647
Trade Balance (US$ billion)	-8.5	-3.2	21.7	35.3	54.5	43.2
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	0.9*	-0.2

*Estimated number

** Estimation of the 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
Head of Industry and Regional Research
agus_lim@bca.co.id
+6221 2358 8000 Ext: 1005314

Barra Kukuh Mamia
Senior Economist
barra_mamia@bca.co.id
+6221 2358 8000 Ext: 1053819

Victor George Petrus Matindas
Senior Economist
victor_matindas@bca.co.id
+6221 2358 8000 Ext: 1058408

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

Keely Julia Hasim
Economist / Analyst
keely_hasim@bca.co.id
+6221 2358 8000 Ext: 1071535

Elbert Timothy Lasiman
Economist / Analyst
Elbert_lasiman@bca.co.id
+6221 2358 8000 Ext: 1074310

Thierris Nora Kusuma
Economist / Analyst
thierris_kusuma@bca.co.id
+6221 2358 8000 Ext: 1071930

Arief Darmawan
Research Assistant
arief_darmawan@bca.co.id
+6221 2358 8000 Ext: 20364

Firman Yosep Tember
Research Assistant
firman_tember@bca.co.id
+6221 2358 8000 Ext: 20378

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