

Facing the intensifying challenge amid the temporary East-West divergence

21 August 2023

Lazuardin Thariq Hamzah
lazuardin_hamzah@bca.co.id

Barra Kuku Mamia
barra_mamia@bca.co.id

Summary

- Minutes from the July 2023 FOMC meeting confirm the Fed's higher-for-longer outlook, which may send the Fed funds rate into parity with BI 7DRR by the remainder of 2023.
- The Fed's hawkish signal, coupled with the increasingly dovish expectations on central banks in Asia, further underlines the challenge that could hit the Indonesian financial market.
- The still-open door for a Fed pivot scenario, albeit not in the near term, may encourage BI to step up market interventions to stabilise the domestic market in the short term rather than opting for other policies that may require higher commitment such as raising the policy rate.

- Two economic events from the last week are particularly relevant to the Indonesian economy. The first one is the announcement of the proposed 2024 state budget, [which we covered last Friday](#). The other one is the release of minutes from the July 2023 FOMC meeting, which reveals FOMC members' assessment on the strengthening US economy compared to the conditions observed during the June 2023 FOMC meeting.
- The continued resilience of the US economy is often attributed to the downward trend in global goods prices, driven by the release of Chinese manufacturers' excess inventory. However, recent developments show that a strong internal market due to the persistent increase in consumption levels amidst the

decline in goods prices may not be the only factor that explains the US economy's strong performance (*see Chart 1*). The Biden administration's industrial onshoring and pro-jobs agenda led to increased government expenditures, which now also have to finance subsidies aimed at attracting investment on top of the still-substantial social spending amidst lower tax revenues. This expansion in government expenditures on investment subsidies stimulates the increase in non-residential fixed-asset investments – complementing the robust consumption level in boosting the economic growth engine in the US.

- The peculiar condition in the US residential market explains another factor that explains the heating US economy. The surge in

mortgage refinancing during the pandemic year has made property owners reluctant to sell, while the currently elevated interest rates are constraining construction activities. Evident signs of undersupply in the US housing market prompt property developers to expand construction efforts, resulting in a rise in residential fixed-asset investments that may appear to stimulate the US economy in Q3-2023. The housing undersupply problem also contributes positively to the US economy by stabilising housing prices, generating a positive net wealth effect that encourages Americans to sustain their consumption levels.

“High inflation rates, robust consumption, and declining central bank’s bond-buying programmes characterise the years 2007 and 2023”

- The continued resilience and potential overheating of the US economy in Q3-2023 bode well with the Fed’s concerns regarding the risks posed by supply shocks. Excerpts from the July 2023 FOMC minutes reveal the Fed’s concern over continued upside risks to inflation, which coupled with the hitherto robustness of the economy, reinforce their determination to continue implementing necessary measures to achieve the sacrosanct 2% inflation target.
- The Fed’s commitment to achieving the 2% inflation target is not unexpected, given the enduring strength of the US economy and the potential supply shock risks that could

trigger another round of inflationary pressures. However, while American businesses and consumers insofar appear to be able to stomach this lengthened hawkish posture, investors in the US bond market continue to suffer from it (*see Chart 2*). Indeed, the US treasury market experienced a substantial sell-off pressure in the days following the release of the FOMC minutes, sending the benchmark 10Y yield to its highest level since 2007.

- The historical parallel between the prevailing 10Y UST yield and the levels observed in 2007 is rather striking. 2007 and 2023 share several traits, ranging from robust US consumption

levels, higher inflation rates, concerns over (energy) commodity supplies, and decreasing bond-buying programmes by the Bank of Japan. Both 2007 and 2023 also stand on the tail of the Fed’s tightening campaign, which the Fed continued to pursue in 2007 given the risk of re-spiking inflation following the peak in mid-2006. Given the historical parallel, the Fed may not want to risk a replay of the double-peak inflation in 2006 and early 2008, and the upcoming Jackson Hole symposium would provide Chairman Powell and co with a proper pulpit to resonate their higher-for-longer stance.

Diverging expectations in Asia

- The economic situation now confronting Fed officials stands in contrast to that of their

counterparts across the Pacific. Faced with plummeting external demand and chronic

deficiency in domestic consumption, the People's Bank of China again trimmed the primary lending rate (1-year loan prime rate) by 10bps to a record-low of 3.45%.

- It should be noted, however, that the most recent round of rate cuts by the PBoC was less aggressive than the market's expectations of a 15bps rate cut for both the 1-year and 5-year LPR. These less-aggressive moves might be linked to the PBoC's decision to defend the CNY's value at 7.1987/USD, contrary to the anticipated 7.2893/USD. Nonetheless, the looser LPR may breed the expectation that other Asian central banks may follow China's move, either to stimulate the economy amidst reduced demand from Chinese consumers or competitive devaluations aimed at preserving export competitiveness in the global market.
- The expectation that Asian central banks may start to cut rates ahead of the still-hawkish Fed and other Western central banks is further bolstered by the Bank of Japan's indecisiveness regarding its plan for the yield curve control policy. The higher-than-expected Shunto (wage re-negotiations) result in March 2023 moves the new BoJ governor to signal an end to the YCC policy. Nevertheless, despite the exceptional 6.0% GDP growth in Q2 2023, inflationary pressures in Japan appear to be subsiding. Adding to the concern is that the weakening

inflationary trend emerged following the BoJ's decision to enhance the flexibility of the YCC policy during the July 2023 meeting.

- These contradicting developments in Western central banks and Asian central banks thus lead to what now resembles a twofold challenge. In addition to the Fed's persistent hawkish signal, the weakening economic impulse in Asian economic powerhouses also dampened sentiments in the Asian market, causing financial assets denominated in Asian currencies to lag behind their global counterparts (*see Chart 3*).
- Fortunately, the Indonesian market remains in better shape relative to its Asian peers.

Nevertheless, the existing stability in the domestic financial market appears to stem from internal factors, such as prudent fiscal control and sustained demand from domestic non-bank investors. Meanwhile, the demand for Indonesian

assets from foreign investors appears to be diminishing, which shows that the Indonesian financial market is not immune to worsening global sentiment toward its Asian counterparts. Thus, while domestic factors may contribute to maintaining stability in the domestic financial market, the disparity in policy expectations between the Fed and Asian central banks might persist in exerting downward pressure on IDR-denominated assets.

"The weakening economic impulse in Asian economic powerhouses also dampened sentiments in the Asian market "

Spotting an ebb amid the flow of soft landing optimism

- The one big hope that Asian investors could cling on to may lie in what happened after the high yield episode in 2007. The parallels in this regard may not be as strong, but they are present nevertheless. Despite the growing support for the “soft landing” expectation, the continued decline in the US personal saving rate reveals that the US economy may be running out of fuel to keep its growth machine alive (*see Chart 4*).
- Subsidies and other benefits extended to IRA and CHIPS acts’ recipients may also necessitate more issuance of UST securities, potentially leading to the fiscal overhang that would force the Fed to change course. Moreover, continued use of the Fed’s lending facility, such as the Bank Term Funding Programme (BTFP), also indicates the still-unstable condition in the US regional banking sector, keeping the door open for a detrimental credit event that may significantly reduce new demand for housing. All these scenarios may eventually force the Fed to forgo its higher-for-longer outlook, alleviating the pressure on other currencies as the USD’s value declines.
- The “Fed pivot” expectation that is still alive in the medium-to-long term should encourage Bank Indonesia not to break ranks and join the Fed in singing the hawkish tune to ward off the prevailing short-term challenges, even if the policy rate spread between the Fed and BI eventually reach parity. Indeed, responding to the risk of parity in the short term may result in a Faustian exchange, as such short-termism would undermine the consistency of BI’s policy signals. Nonetheless, interventions that demand lower policy commitment, such as open market operations, may be needed to stabilise the domestic market in the short term. This condition underscores the significance of the government’s strengthened DHE policy, given the potential drain in BI’s FX coffers in periods ahead.

“Still-unstable condition in the US banking sector, weakening consumption due to the spent excess saving, and the risk of fiscal overhang may force the Fed to lower the interest rate ”

Chart 1

Match and timbers

Expanding government expenditures and fixed-asset investments continue to fuel the US economy, which hitherto benefits from robust consumption levels.

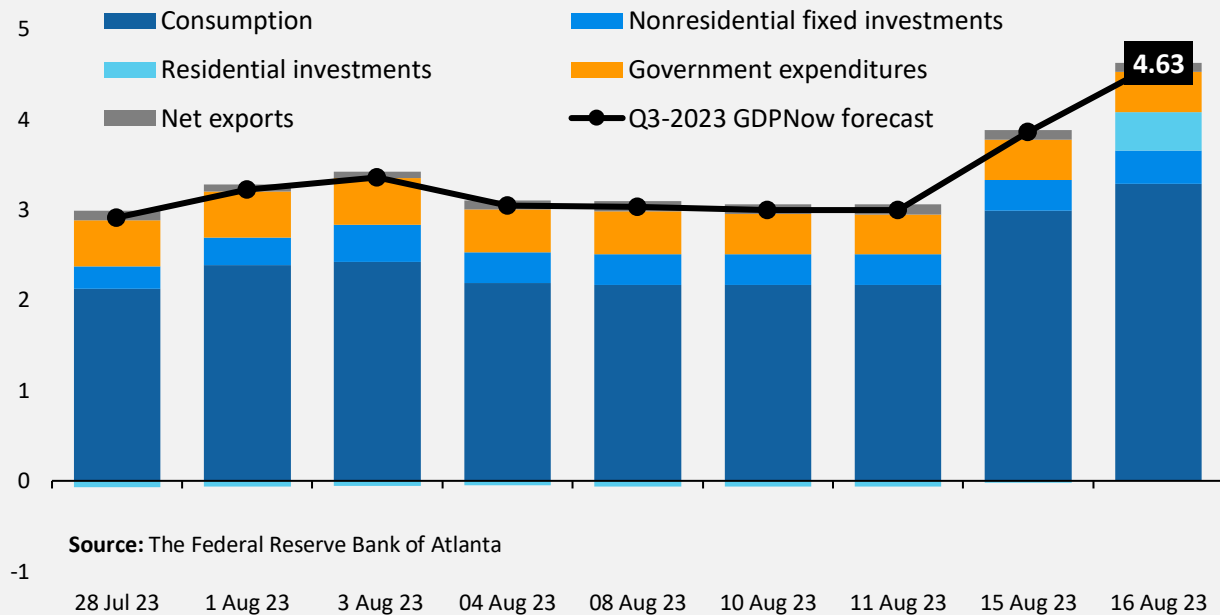


Chart 2

Move where the rate expectation goes

Rate expectations, rather than concerns over worsening fiscal condition due to debt overhang, continue to drive the sell-off in the UST market

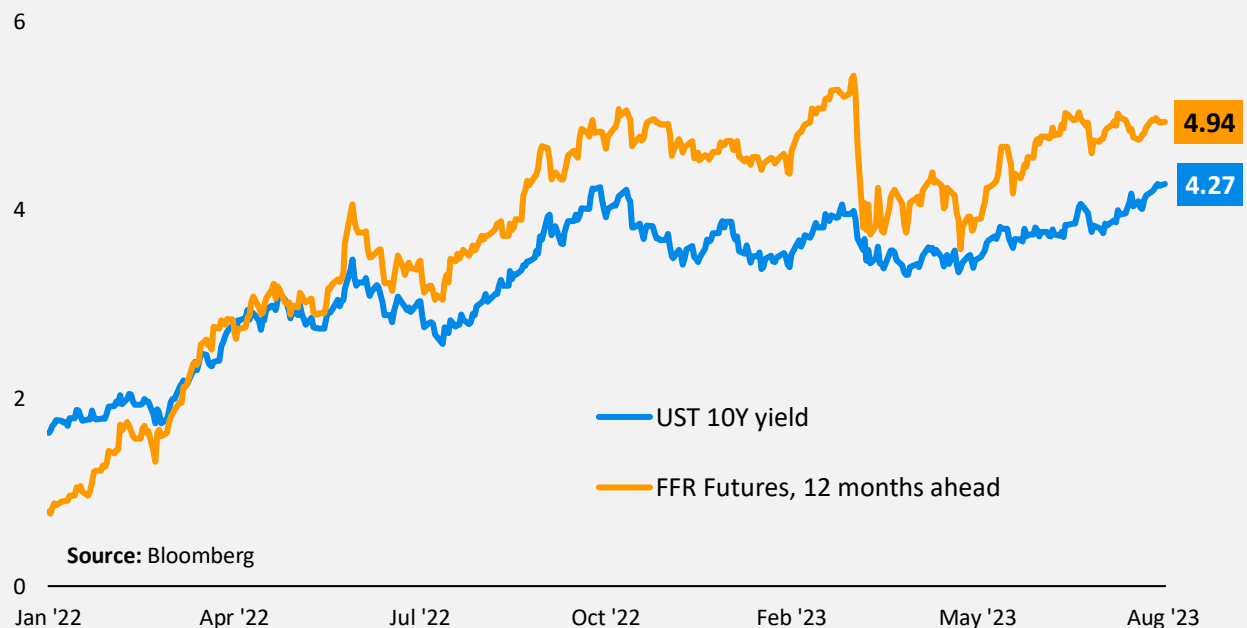


Chart 3

The endemic of bad sentiments

Asian assets are lagging against its global peers thanks to worsening sentiment in Asian economic powerhouses

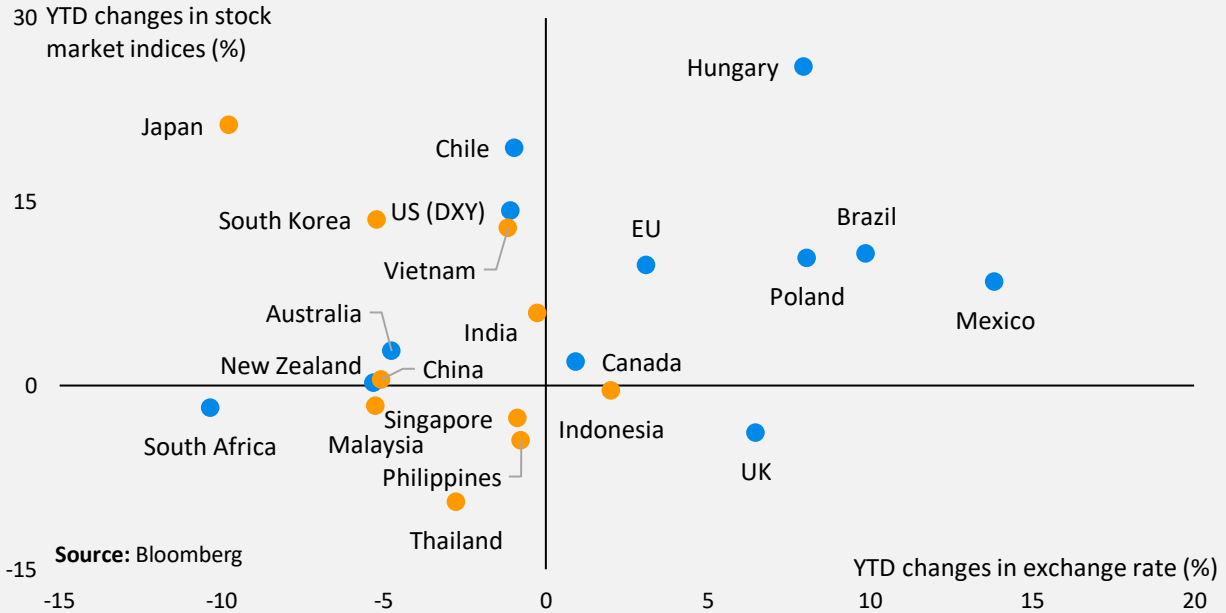
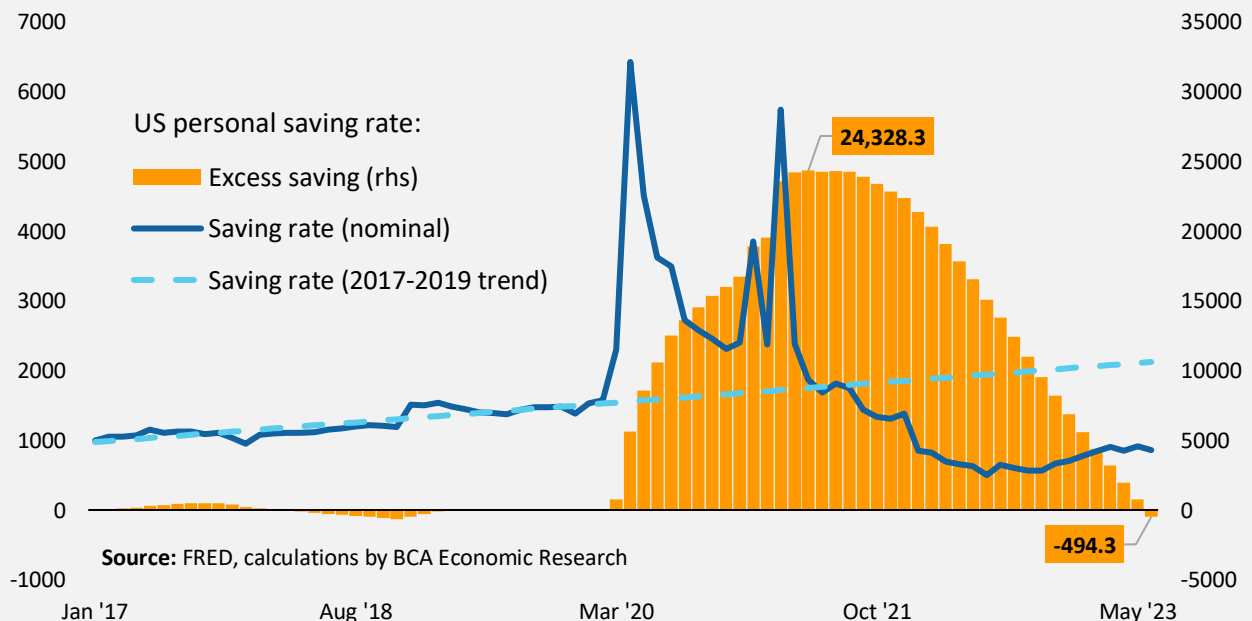


Chart 4

Spent rounds

The soft landing expectation has been gaining stream lately, but the prevailing consumption level in the US may not be sustainable given the spent pandemic-era excess saving



Economic Calendar				
		Actual	Previous	Forecast*
1 August 2023				
ID	S&P Manufacturing PMI	53.3	52.5	52
ID	Inflation Rate YoY	3.08%	3.52%	3.2%
CN	Caixin Manufacturing PMI	49.2	50.5	50.3
US	S&P Manufacturing PMI	49	46.3	49
US	JOLTs Job Opening	9.582	9.616	9.6
3 August 2023				
UK	BoE Bank Rate Decision	5.25%	5.00%	5.00%
4 August 2023				
US	Unemployment Rate	3.5%	3.6%	3.6%
US	Non-Farm Payroll ('000)	187	185	200
7 August 2023				
ID	Foreign Exchange Reserves (USD (Bn))	137.7	137.5	140.0
ID	GDP Growth Rate YoY	5.17%	5.03%	5.1%
CN	Foreign Exchange Reserves (USD Tn)	3.20	3.19	3.19
8 August 2023				
ID	Consumer Confidence	123.5	127.1	127.5
CN	Balance of Trade (USD Bn)	80.6	70.6	69
US	Balance of Trade (USD Bn)	-65.5	-69	-65.1
9 August 2023				
CN	Inflation rate YoY	-0.3%	0%	-0.3%
ID	Motorbike Sales YoY	45.6%	66.6%	-
ID	Retail Sales YoY	7.9%	-4.5%	3.1
10 August 2023				
US	Inflation rate YoY	3.2%	3%	3.1%
ID	Car Sales YoY	-6.7%	4.6%	-
15 August 2023				
ID	Balance of Trade (USD Bn)	1.31	3.46	2.7
CN	Retail Sales YoY	2.5%	3.1%	4.6%
US	Retail Sales YoY	3.2%	1.6%	1.0%
22 August 2023				
ID	Current Account (USD Bn)	-	3.0	-1.6
24 August 2023				
ID	Interest Rate Decision	-	5.75%	5.75%

*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 (%)	Trade & Commodities	18-Aug	-1 mth	Chg (%)
US	5.50	Aug-23	2.30	Baltic Dry Index	1,237.0	1,037.0	19.3
UK	5.25	Aug-23	-1.55	S&P GSCI Index	582.0	564.2	3.2
EU	4.25	Aug-23	-1.05	Oil (Brent, \$/bbl)	84.8	79.6	6.5
Japan	-0.10	Jan-16	-3.40	Coal (\$/MT)	162.7	142.4	14.3
China (lending)	4.35	Aug-23	4.65	Gas (\$/MMBtu)	2.44	2.53	-3.6
Korea	3.50	Jul-23	1.20	Gold (\$/oz.)	1,889.3	1,978.7	-4.5
India	6.50	Aug-23	-0.94	Copper (\$/MT)	8,213.8	8,445.0	-2.7
Indonesia	5.75	Jul-23	2.67	Nickel (\$/MT)	19,907.0	20,840.0	-4.5
Money Mkt Rates	18-Aug	-1 mth	Chg (bps)	CPO (\$/MT)	830.2	853.1	-2.7
SPN (1M)	5.28	5.23	5.7	Rubber (\$/kg)	1.27	1.28	-0.8
SUN (10Y)	6.49	6.20	29.4	External Sector	Jul	Jun	Chg (%)
INDONIA (O/N, Rp)	5.54	5.57	-2.8	Export (\$ bn)	20.88	20.60	1.36
JIBOR 1M (Rp)	6.40	6.40	0.1	Import (\$ bn)	19.57	17.15	14.10
Bank Rates (Rp)	May	Apr	Chg (bps)	Trade bal. (\$ bn)	1.31	3.45	-61.96
Lending (WC)	8.93	8.92	0.35	Central bank reserves (\$ bn)*	137.7	137.5	0.12
Deposit 1M	4.19	4.18	1.37	Prompt Indicators	Jul	Jun	May
Savings	0.67	0.67	0.00	Consumer confidence index (CCI)	123.5	127.1	128.3
Currency/USD	18-Aug	-1 mth	Chg (%)	Car sales (%YoY)	-6.8	4.7	65.2
UK Pound	0.785	0.767	-2.32	Motorcycle sales (%YoY)	45.6	66.6	113.4
Euro	0.920	0.891	-3.17	Manufacturing PMI	Jul	Jun	Chg (bps)
Japanese Yen	145.4	138.8	-4.51	USA	46.4	46.0	40
Chinese RMB	7.285	7.186	-1.35	Eurozone	42.7	43.4	-70
Indonesia Rupiah	15,285	14,995	-1.90	Japan	49.6	49.8	-20
Capital Mkt	18-Aug	-1 mth	Chg (%)	China	49.2	50.5	-130
JCI	6,859.9	6,830.2	0.43	Korea	49.4	47.8	160
DJIA	34,500.7	34,951.9	-1.29	Indonesia	53.3	52.5	80
FTSE	7,262.4	7,453.7	-2.57				
Nikkei 225	31,450.8	32,493.9	-3.21				
Hang Seng	17,950.9	19,015.7	-5.60				
Foreign portfolio ownership (Rp Tn)	Jul	Jun	Chg (Rp Tn)				
Stock	2,892.9	2,755.0	137.88				
Govt. Bond	846.9	846.9	0.00				
Corp. Bond	11.3	11.3	-0.03				

Source: Bloomberg, BI, BPS

Notes:

Car and motorcycle sales data to be released on the third week of January 2022

^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



Scan for the link to our report depository or click:

https://s.id/BCA_REI

Indonesia – Economic Indicators Projection

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	5.2
GDP per Capita (US\$)	3927	4175	3912	4350	4784	5285
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	2.7
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	15,173
Trade Balance (US\$ billion)	-8.5	-3.2	21.7	35.3	54.5	35.3
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	1.0	-0.7

*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

Victor George Petrus Matindas

Senior Economist

victor_matindas@bca.co.id

+6221 2358 8000 Ext: 1058408

Keely Julia Hasim

Economist / Analyst

keely_hasim@bca.co.id

+6221 2358 8000 Ext: 1071535

Agus Salim Hardjodjodito

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

Elbert Timothy Lasiman

Economist / Analyst

Elbert_lasiman@bca.co.id

+6221 2358 8000 Ext: 1074310

Firman Yosep Tember

Research Assistant

firman_tember@bca.co.id

+6221 2358 8000 Ext: 20378

Barra Kukuh Mamia

Senior Economist

barra_mamia@bca.co.id

+6221 2358 8000 Ext: 1053819

Lazuardin Thariq Hamzah

Economist / Analyst

lazuardin_hamzah@bca.co.id

+6221 2358 8000 Ext: 1071724

Thierris Nora Kusuma

Economist / Analyst

thierris_kusuma@bca.co.id

+6221 2358 8000 Ext: 1071930

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

DISCLAIMER

This report is for information only, and is not intended as an offer or solicitation with respect to the purchase or sale of a security. We deem that the information contained in this report has been taken from sources which we deem reliable. However, we do not guarantee their accuracy, and any such information may be incomplete or condensed. None of PT. Bank Central Asia Tbk, and/or its affiliated companies and/or their respective employees and/or agents makes any representation or warranty (express or implied) or accepts any responsibility or liability as to, or in relation to, the accuracy or completeness of the information and opinions contained in this report or as to any information contained in this report or any other such information or opinions remaining unchanged after the issue thereof. The Company, or any of its related companies or any individuals connected with the group accepts no liability for any direct, special, indirect, consequential, incidental damages or any other loss or damages of any kind arising from any use of the information herein (including any error, omission or misstatement herein, negligent or otherwise) or further communication thereof, even if the Company or any other person has been advised of the possibility thereof. Opinion expressed is the analysts' current personal views as of the date appearing on this material only, and subject to change without notice. It is intended for the use by recipient only and may not be reproduced or copied/photocopied or duplicated or made available in any form, by any means, or redist ted to others without written permission of PT Bank Central Asia Tbk.

All opinions and estimates included in this report are based on certain assumptions. Actual results may differ materially. In considering any investments you should make your own independent assessment and seek your own professional financial and legal advice. For further information please contact: (62-21) 2358 8000, Ext: 20378 or fax to: (62-21) 2358 8343 or email: firman_tember@bca.co.id