

## BI Policy:

# Staring down the barrel

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### Executive Summary

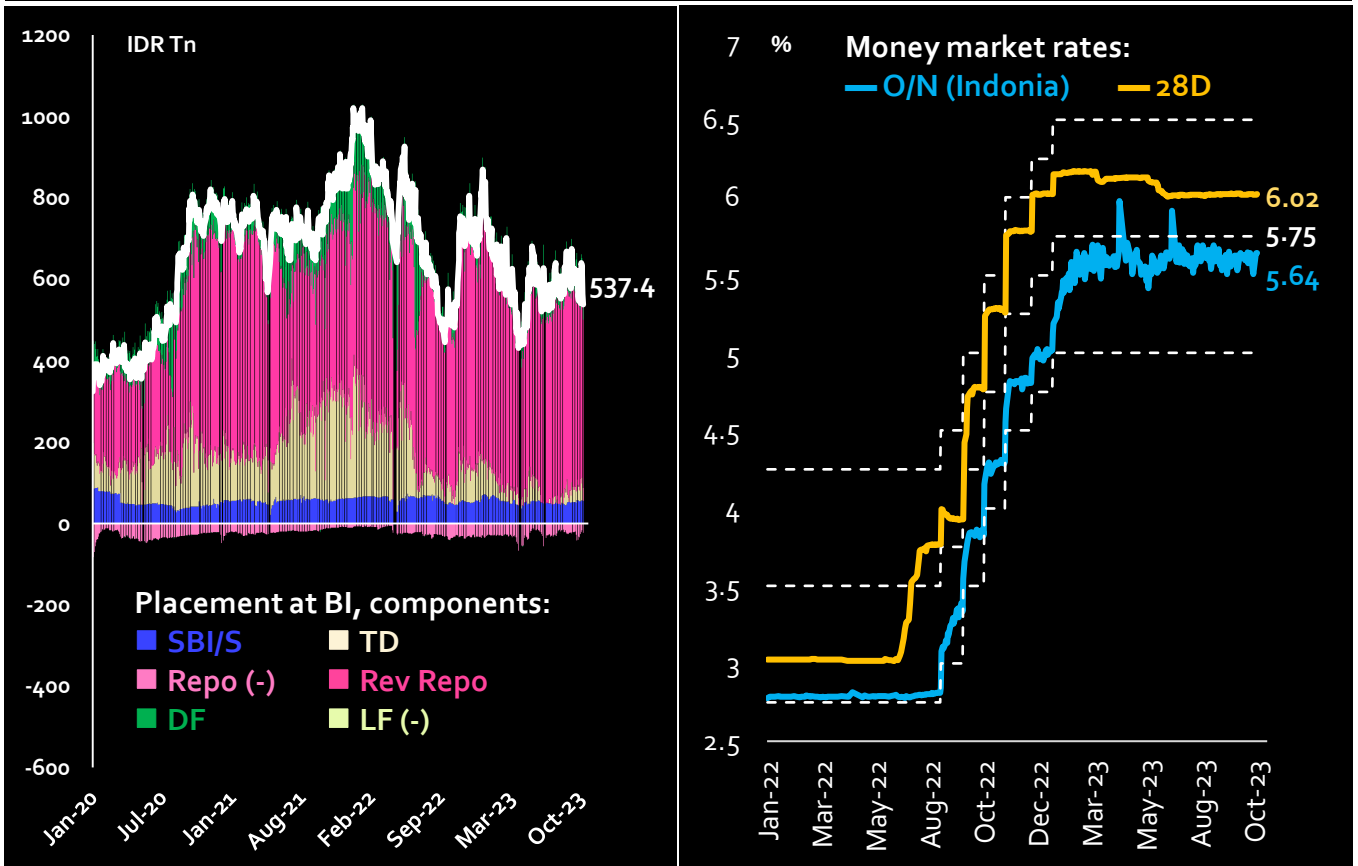
- BI raises the BI7DRR to 6.00%, 25bps hike, after an eight-month break reflecting the unique global market conditions and BI's response.
- Global economic conditions have changed significantly with the return of supply disruptions great power conflict and fiscal expansion, leading to a "high-pressure economy" characterized by strong growth and employment combined with higher inflation.
- Economic activities have bottomed out in mid-year and but are starting to pick up again. This upshot of the new global economy, is not just higher rates for the long-haul – but also that growth may hold up better despite those higher rates.
- Although an increase in interest rates can suppress demand and stabilize the Rupiah in the short term, this is not without consequences, and the direction of BI interest rates will depend greatly on global market developments, so BI will review the situation on a month-to-month basis.

- After an eight month pause, and confounding the majority of analysts, BI is finally raising rates again in response to renewed pressures on the Rupiah. This decision is, in a way, quite unprecedented. For the past decade and more, BI has never hiked when the real policy rate is at such a high level. Monetary conditions have rarely been this tight – and yet BI feels compelled to tighten it further.
- This speaks to both the "weirdness" in the global market and BI's reaction function to it. The former reflects a global economy that is very different from "the Great Moderation" that we are used to for the past three decades or so. The return of supply disruptions, great power conflict, and the willingness of the protagonists, US and China, to spend big to win the contest despite high debt loads are straining bond valuations – to the point that the term "bond vigilantes", usually consigned to history books or peripheral/emerging markets, are now being bandied about when speaking of US Treasuries.
- But this fiscal expansiveness is also boosting growth. China's data are strengthening again despite fears over the fallout from its real estate crisis, while the US economy has kept marching on despite the UST yield curve being inverted for so long – and is now in the process of re-steepening. The result, then, is a "high-pressure economy": strong growth and employment combined with high(er) inflation. We are not in Kansas (the neoliberal era) anymore.

- In this new economy, old models resting on old assumptions no longer works. Current Fed rates are not enough to quell US inflation, which is why the market has violently shifted to expecting “higher-for-longer”. This naturally affects asset prices across the world, and Indonesia is no exception. What was once enough to stabilize the Rupiah – real policy rates of around 2.5 – 3.5% – may no longer be sufficient.
- Central banks used to have the luxury to ease policy or at least stay put when inflation declines, as has been the case for Indonesia. But with US Treasuries gobbling up global liquidity and geopolitical tensions continuing to escalate, this cannot be taken for granted anymore – which takes us to BI’s reaction function.
- Perhaps due to the experience of 1998, Indonesian policymakers have a relative reluctance to let the currency depreciates to correct macro imbalances. Rupiah’s recent weakness is almost entirely down to global factors – including falling coal prices, which flipped its CA to negative and accounted for the Rupiah’s recent underperformance versus other Asian currencies.
- There are two options to remedy this: either let the Rupiah fall further to a certain equilibrium point that would restore the CA, or hike rates to suppress demand and conserve liquidity at home. Staring down the barrel of the vigilantes, then, BI chose the latter route.
- This may work as a one-off tactic that would reiterate BI’s commitment to Rupiah stability and scare away the vigilantes – an EM version of Mario Draghi’s “whatever it takes” that does not require further actions. However, if we are correct in our assessment of a more turbulent, “higher pressure” global economy ahead, the vigilantes could return for more – making it the start of a new rate hike cycle. BI’s rate trajectory, then, will depend on what happens in the global market, which aligns with Gov. Warjiyo’s remark that the situation will be “reviewed month to month”.
- As we noted previously, any route that BI takes to prevent IDR depreciation comes with a cost: FX intervention erodes reserves, SRBI reduces liquidity, while hiking the 7-day Repo Rate signals higher borrowing costs ahead. In this regard, the last option seems the least costly in the short-term as its effects usually come with a lag – but much of this will also hinge on other points in the yield curve, which have been rising even before BI’s latest move. Note that 6-month SRBI is already offering 6.32-6.33% – meaning that the policy rate hike simply “rubberstamps” what the tightening market has wanted all along.
- We would argue, however, that the opportunity loss in terms of growth is relatively small compared to the tailwinds that we could be enjoying. Fiscal expansion in China and the US should have trickle down effects on Indonesia, while the government is also sitting on a sizable cushion of savings, ready to be deployed should the need arise. Our observation of BCA’s transaction data also suggests that activities have bottomed out in mid-year and is starting to pick up again. The upshot of the new global economy, then, is not just higher rates for the long-haul – but also that growth may hold up better despite those higher rates.

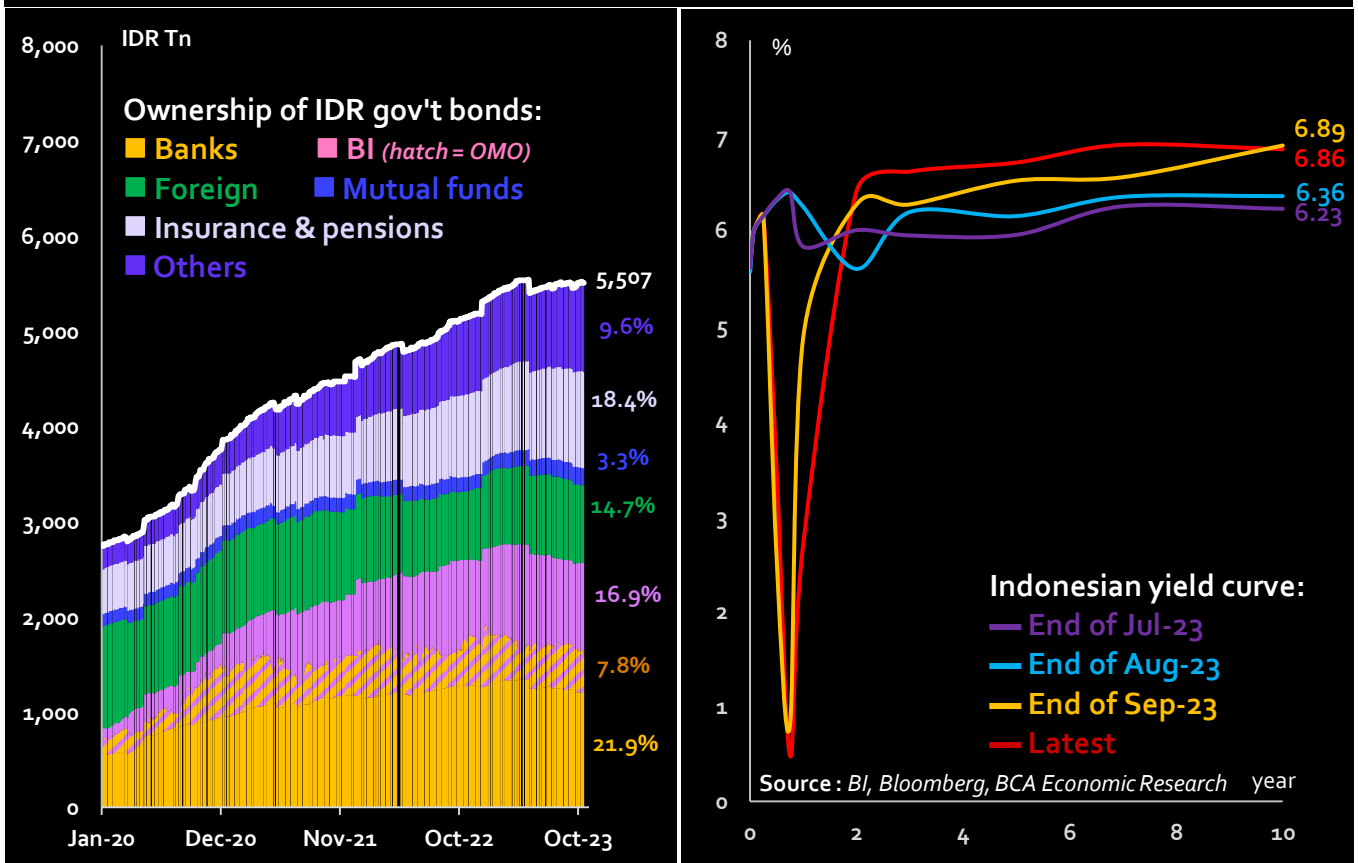
- BI rounded out its meeting by announcing the issuance of new instruments – Foreign Currency Securities (SVBI) and Foreign Currency Sukuk (SUVBI) – which are essentially the FX counterparts of SRBI. Despite the similarities, however, the difference in currencies greatly changes their impact. Whereas SRBI works by restricting the supply of IDR liquidity, SVBI and SUVBI are supposed to add to BI's FX reserves. Given the tight FX liquidity currently, the latter two are unlikely to be instant hits in the same way as SRBI was last month. Still, they may prove to be valuable additions to BI's arsenal in the long run, especially when paired with stronger enforcement of the export receipts (DHE) regulations.

**Panel 1. BI hikes rate, further contraction reducing liquidity in the system**



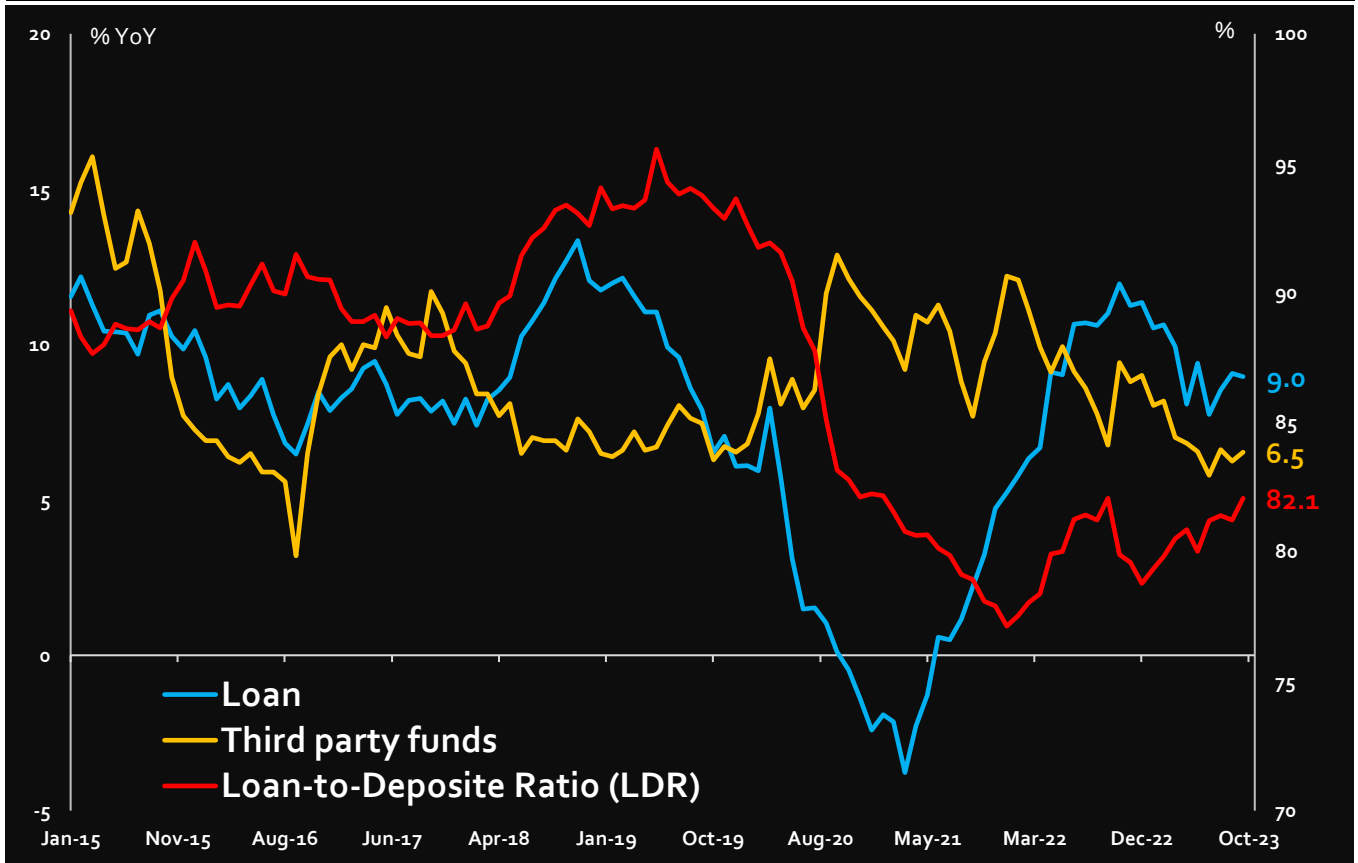
Source: BI, Bloomberg, BCA Economist

**Panel 2. Bear steepening in UST puts similar pressure on long-dated Indonesian bonds**



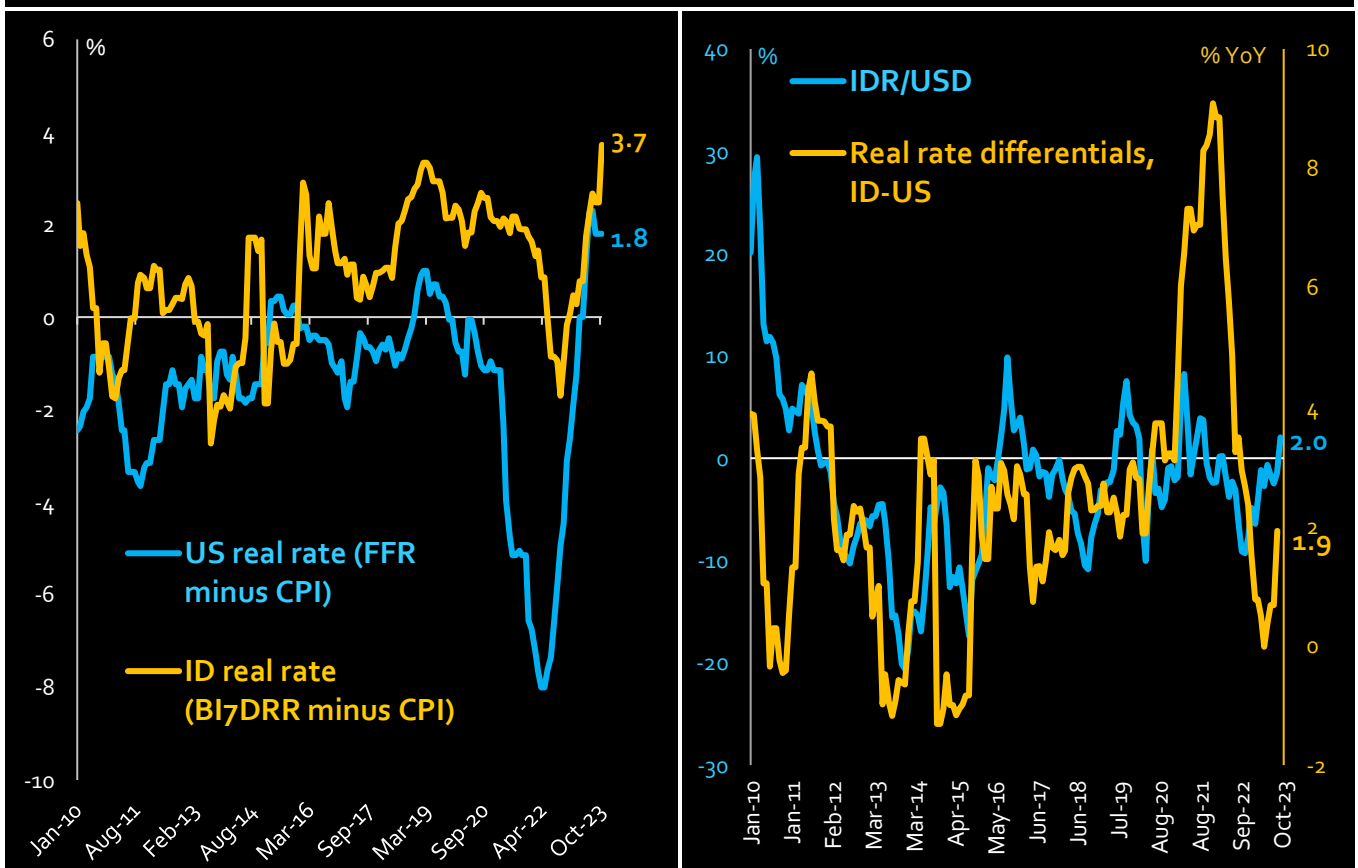
Source: MoF, BI, Bloomberg, BCA Economist

**Panel 3. Loan growth experience a slight decline, with BI rate hikes adding more pressure**



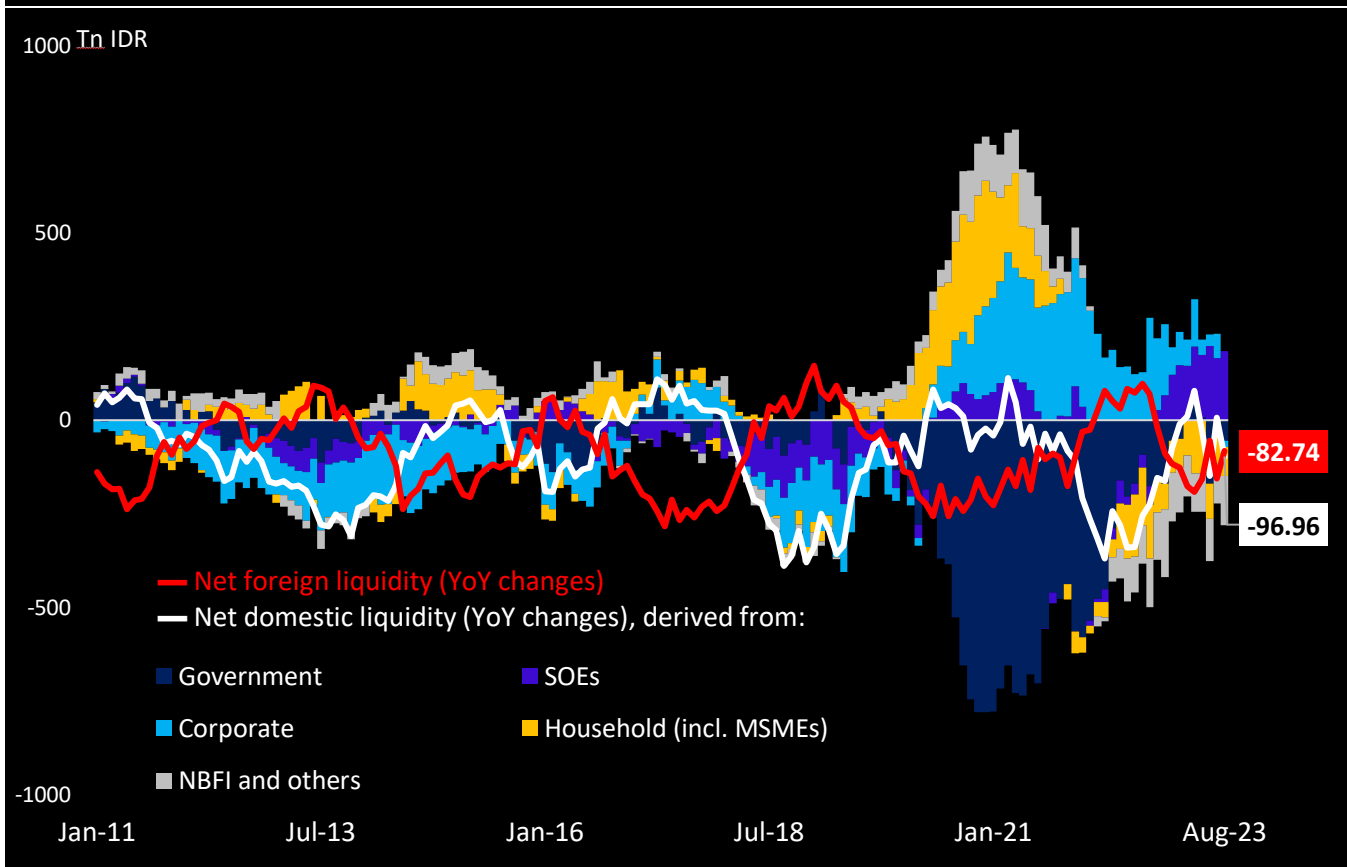
Source: OJK, BI, BCA Economist

**Panel 4. Real rate differentials getting wider, not as predictive USD/IDR as it should be**



Source: BI, Bloomberg, BCA Economist

**Panel 5. Outflows put pressure on FX liquidity despite relatively stable CA deficit outlook for H2-23**



Source: BI, BCA Economist

## Selected Macroeconomic Indicators

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	18-Oct	-1 mth	Chg (%)
US	5.50	Oct-23	1.80	Baltic Dry Index	2,105.0	1,381.0	52.4
UK	5.25	Oct-23	-1.45	S&P GSCI Index	599.0	618.1	-3.1
EU	4.50	Oct-23	0.20	Oil (Brent, \$/bbl)	91.5	93.9	-2.6
Japan	-0.10	Jan-16	-3.30	Coal (\$/MT)	150.4	172.6	-12.9
China (lending)	2.50	Sep-23	4.35	Gas (\$/MMBtu)	2.92	2.74	6.6
Korea	3.50	Oct-23	-0.20	Gold (\$/oz.)	1,947.6	1,923.9	1.2
India	6.50	Oct-23	1.48	Copper (\$/MT)	7,901.5	8,350.4	-5.4
Indonesia	6.00	Oct-23	3.72	Nickel (\$/MT)	18,407.0	19,672.5	-6.4
Money Mkt Rates	18-Oct	-1 mth	Chg (bps)	CPO (\$/MT)	789.3	796.1	-0.9
SPN (1M)	6.20	5.65	54.9	Rubber (\$/kg)	1.47	1.42	3.5
SUN (10Y)	6.86	6.67	18.9	External Sector	Sep	Aug	Chg (%)
INDONIA (O/N, Rp)	5.64	5.60	3.9	Export (\$ bn)	20.76	22.00	-5.63
JIBOR 1M (Rp)	6.40	6.40	0.0	Import (\$ bn)	17.34	18.88	-8.15
Bank Rates (Rp)	Jul	Jun	Chg (bps)	Trade bal. (\$ bn)	3.42	3.12	9.61
Lending (WC)	8.95	8.93	2.84	Central bank reserves (\$ bn)*	134.9	137.1	-1.60
Deposit 1M	4.24	4.19	4.92	Prompt Indicators	Sep	Aug	Jul
Savings	0.67	0.67	-0.41	Consumer confidence index (CCI)	121.7	125.2	123.5
Currency/USD	18-Oct	-1 mth	Chg (%)	Car sales (%YoY)	-20.1	-8.3	-6.7
UK Pound	0.824	0.808	-1.96	Motorcycle sales (%YoY)	-0.9	1.8	45.6
Euro	0.949	0.938	-1.14	Manufacturing PMI	Sep	Aug	Chg (bps)
Japanese Yen	149.9	147.9	-1.39	USA	49.0	47.6	140
Chinese RMB	7.317	7.276	-0.56	Eurozone	43.4	43.5	-10
Indonesia Rupiah	15,730	15,353	-2.40	Japan	48.5	49.6	-110
Capital Mkt	18-Oct	-1 mth	Chg (%)	China	50.6	51.0	-40
JCI	6,927.9	6,982.8	-0.79	Korea	49.9	48.9	100
DJIA	33,665.1	34,618.2	-2.75	Indonesia	52.3	53.9	-160
FTSE	7,588.0	7,711.4	-1.60				
Nikkei 225	32,042.3	33,533.1	-4.45				
Hang Seng	17,732.5	18,182.9	-2.48				
Foreign portfolio ownership (Rp Tn)	Sep	Aug	Chg (Rp Tn)				
Stock	2,833.3	2,869.7	-36.44				
Govt. Bond	823.0	846.3	-23.30				
Corp. Bond	10.8	11.1	-0.26				

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

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	5.1
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	2.6
BI 7 day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	6.25
USD/IDR Exchange Rate (end of year)**	14,390	13,866	14,050	14,262	15,568	15,535
Trade Balance (US\$ billion)	-8.5	-3.2	21.7	35.3	54.5	32.8
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	1.0	-0.7

\*Estimated number

\*\* Estimation of Rupiah's fundamental exchange rate

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