

BI and Fed policy:

Back to dark clouds and rainy days

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Executive Summary

- BI and the Fed kept their policy rate unchanged, as returning inflationary pressures encouraged the Fed to strengthen its hawkish signal while the renewed pressure on the IDR discouraged BI from resuming its rate-cutting campaign.
- Rising oil prices may make BI more sensitive to the short-term movement in the IDR's value, as further depreciation in the IDR may translate negatively to the government's fiscal posture.
- BI's interventions have yielded limited results in stimulating loan growth, as rising funding costs – compounded by deteriorating credit quality – hamstrung banks' capacity to expand their loan portfolios.

- This week is a busy one for monetary policy watchers, as central banks from Japan to the US announced their policy rates. But first, let's start with Bank Indonesia. **BI maintained its policy rate at 5.50%, in line with analysts' consensus**, as the central bank continues to face challenges on both the growth and stability fronts of its objectives.
- Indeed, the short-term growth outlook remains a concern for BI officials. In a rare twist, the central bank acknowledged that the potentially higher GDP reading in H1 2025 is likely driven by front-loaded exports to the US, while private consumption and investment still require further support.
- The downward trend in loan growth (8.43% YoY in May 2025, down from 8.88% YoY previously) highlights that BI still has a long to-do list to pump the economy forward – a task made more difficult by the central bank's assessment of banks' growing appetite for paper assets rather than loans. This assessment echoes our expectation that BI will gradually sideline the SRBI market, as it has reduced SRBI outstanding by IDR 112.42 Tn so far in 2025 and has instead encouraged banks to engage in SRBI repo transactions (and other secondary market activities) to prop up liquidity in the interbank market.
- BI's concern over credit supply also stems from banks' increased activity in the SBN market. Banks' holdings of marketable SBNs have risen by IDR 8.02 trillion so far in June 2025, in contrast to declining ownership among other investor groups, as the narrowing SRBI market has prompted banks to re-enter the SBN market.
- Banks' growing appetite for government securities strengthened the rationale for the central bank to maintain its presence in the market. BI has purchased around IDR 87.04 Tn worth of SBN in the secondary market, spending another IDR 37.29 Tn on sharia-compliant debts and government bills (SPN). BI's continued presence in the SBN market has helped suppress yields

as the benchmark 10Y SBN yield is hovering 28.1 bps below the government's 2025 macro assumption. **However, the impact of lower yields on credit supply remains limited, as the tighter lending standards are more accurately attributed to the continued slowdown in deposit growth**, with third-party funds expanding by only 4.29% YoY in May 2025.

- Intensifying competition for liquidity has driven up banks' cost of funds, limiting their ability to offer competitive lending rates. Concurrently, **the scope for loan book expansion is further constrained by worsening asset quality, adding to the overall headwinds facing the banking sector**. This challenge is particularly acute in the consumer credit segment, where non-performing loans surged by 26.4% YoY as of Q1-2025, underscoring the persistent liquidity pressures that have weighed on the household sector since 2023.
- Of particular concern is the sharp increase in mortgage-related NPLs, which NPL ratio rose from 2.34% to 2.89% in the past 12 months (42.9% YoY). Given the property sector's strong multiplier effects across the broader economy, this development raises additional risks. It may also undermine the efficacy of BI's recent expansion of macroprudential liquidity incentives (KLM), which was explicitly aimed to support the property sector.
- The hitherto limited success in pushing banks back into the loan market by suppressing yields in the securities market compels BI to maintain its dovish outlook, with the central bank signalling that it is actively looking for room to further cut the BI-Rate. Alas, **while foreign inflows and a strengthening IDR created optimal conditions for a rate cut last month, the same cannot be said for the period ahead**.
- We have taken a balanced view of the IDR rally in May 2025, arguing that the appreciation was driven more by a weakened USD than by improved domestic fundamentals. Unfortunately for the Indonesian economy, our argument appears to be justified. The USD began to stabilise in mid-June, with the DXY Index appreciating by 1.16% WoW, while the Rupiah shed 0.75% of its value against the USD over the week. Emboldened by its ample FX reserves, BI has signalled its readiness to combat short-term volatility in the Rupiah's value – the same message the central bank conveyed amidst the sharp depreciation in March 2025. However, given the changing geopolitical context and Fed policy signals, it is uncertain whether these dark clouds will be transitory.
- The dark clouds in question refer to the apparent shift in the Fed's stance on inflation. Fed Chairman Powell has made stronger remarks about the inflationary threat posed by tariffs, prompting the market to lower its expectations for FFR cuts in 2025 from 75–100 bps to 50 bps. Vindicating the market, **the Fed maintained the FFR in the 4.25–4.50% range, postponing its rate cut campaign for a fourth consecutive meeting as inflation threats once again knock at the US door**.
- This inflation concern is unlikely to ebb sooner, especially with the ongoing military escalation in the Middle East. While the global oil market remains well-balanced, and most analysts are sceptical that the conflict will result in severe disruption in the Hormuz Strait, there is no telling what Iran might do to the globally crucial oil hub if the conflict further escalates.

"Apart from the limited lending capacity, the worsening credit quality also hamper banks' ability to drive loan growth"

- We should recall that stable US CPI inflation is largely due to the negative contribution from the energy component, which in turn reflects the downward trend in oil prices since 2024. As such, **the recent U-turn in oil prices may lead to a similar reversal in the energy component's contribution to the US inflation figure.** Together with the tariff-impacted rise in the core goods component, this helps explain the upward revision in the Fed's 2025 inflation guidance to 3.0% YoY.

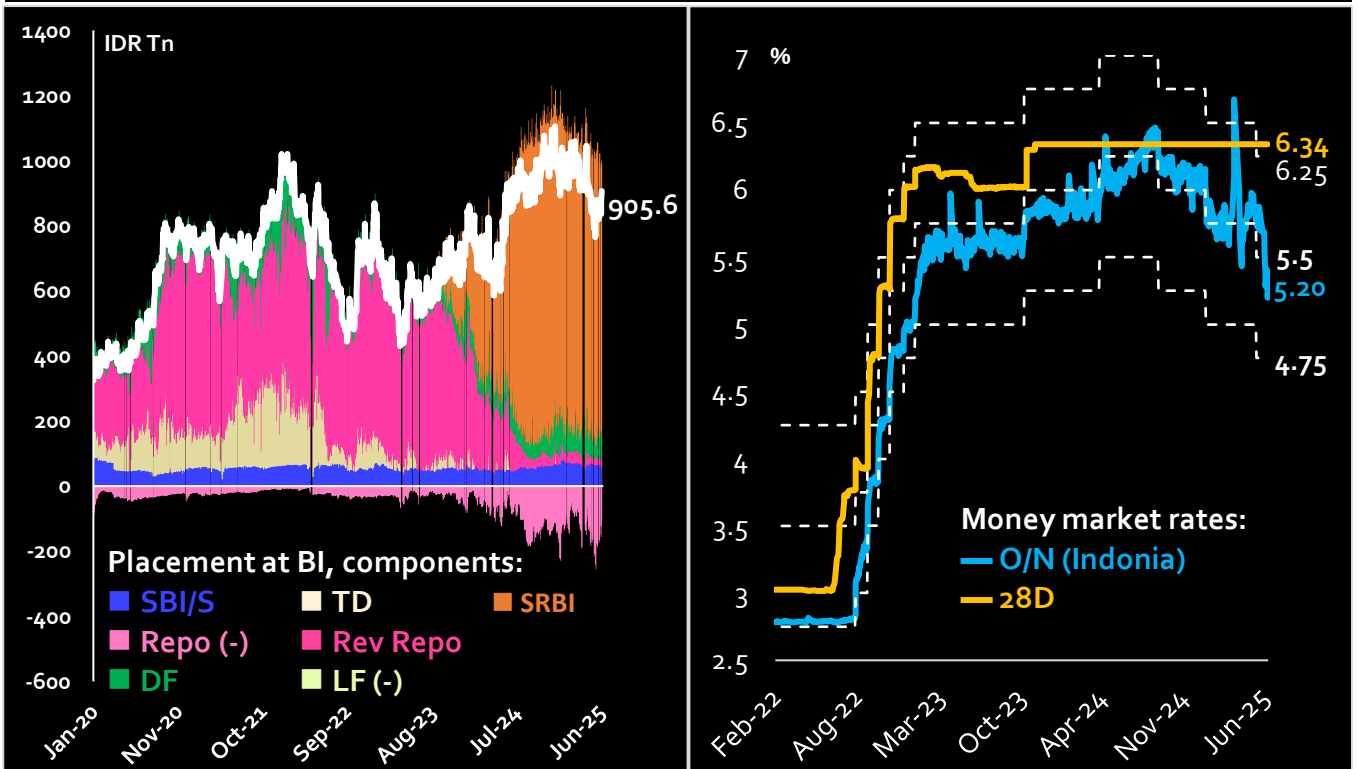
- Unfortunately, inflation is hardly the only concern for the Fed. FOMC members have also downwardly revised their 2025 growth outlook – from 1.7% in the March 2025 projections to 1.4% YoY – with tariff-related disruptions once again being used to justify the stagflation

"The Fed's decision to strengthen its hawkish signal is not without risk, considering the continued build-up of US federal debt"

narrative. Historical precedent suggests that the Fed will prioritise combating inflation in a stagflationary environment, although doing so amidst the anticipated debt-financed US fiscal expansion (due to the 'Big, Beautiful' budget bill) entails considerable risks of its own.

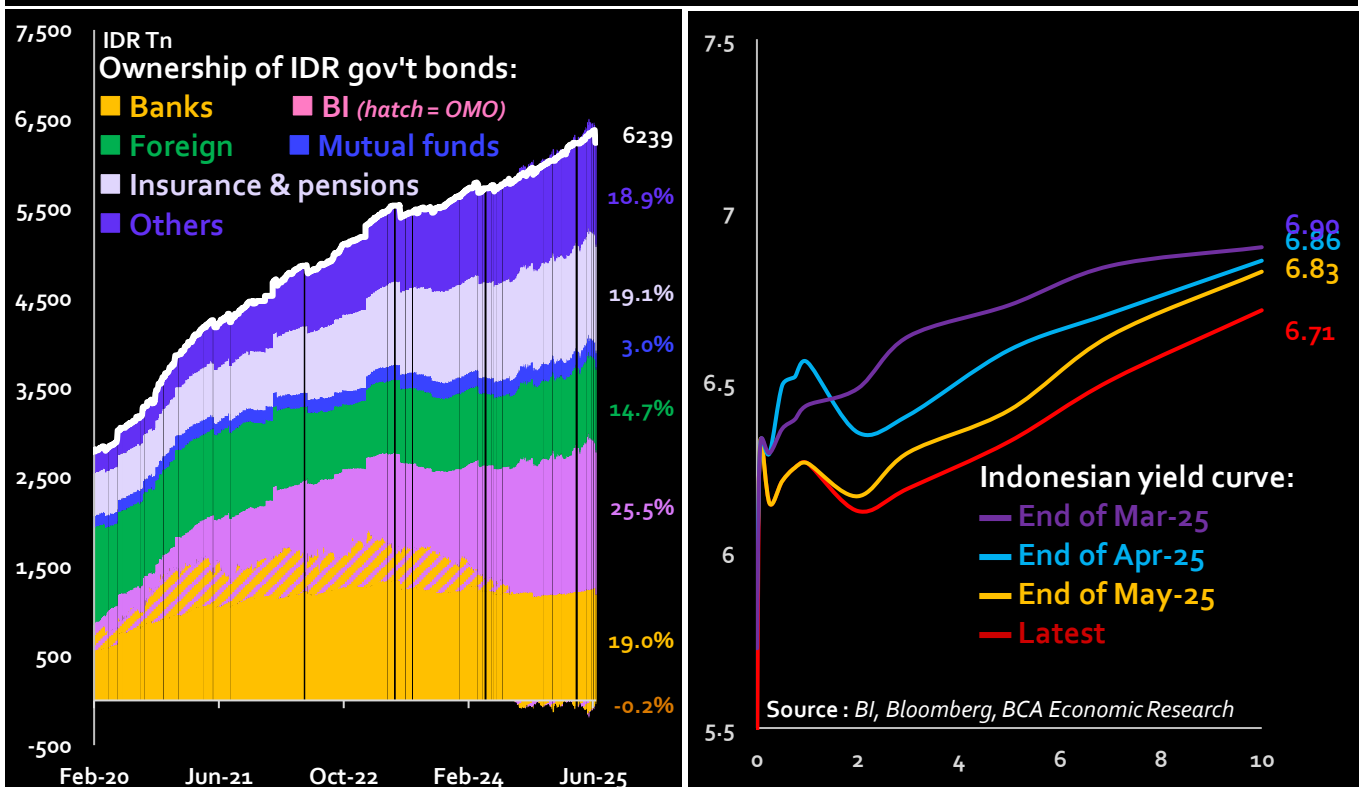
- Some traders have aired their expectation that the Fed will eventually 'chicken out' on its fight for 2% inflation. For instance, debt issuance amidst the prevailing high-rate environment may sizably increase the US' interest burden, undermining the sentiment on the UST that may force the Fed to react. Moreover, a substantial deterioration in labour market conditions could also weaken the Fed's inflation-fighting posture. Nevertheless, with Chair Powell's term not set to expire until May 2026, it may be premature to discount the Fed's resolute to quell inflation.
- We may expect, then, for the USD to make a comeback in the next couple of months. Statements following yesterday's FOMC meeting have led to more market participants expecting a single 25 bps FFR cut in 2025. Meanwhile, **the US Treasury Department is also expected to issue a sizable number of T-bills once the 'Big, Beautiful' budget bill is signed into law, potentially siphoning liquidity away from other markets (including Indonesia) and back to the US market.**
- Given the prevailing external dynamics, the outlook for further monetary easing by Bank Indonesia has become increasingly uncertain, as the stabilising DXY index has effectively stalled the Rupiah's recovery. **The recent rebound in global oil prices, and its potential implications for fiscal sustainability, also suggests that a more cautious approach to rate cut implementation may be warranted.** Nonetheless, the case for further reductions in the BI-Rate remains strong, particularly as the public sector is constrained by revenue shortfall and, thus, cannot be relied upon to provide meaningful support to the aggregate demand condition.

Panel 1. Decreasing SRBI issuance allows BI to lower the SRBI yield, forcing banks to switch back to the SBN market



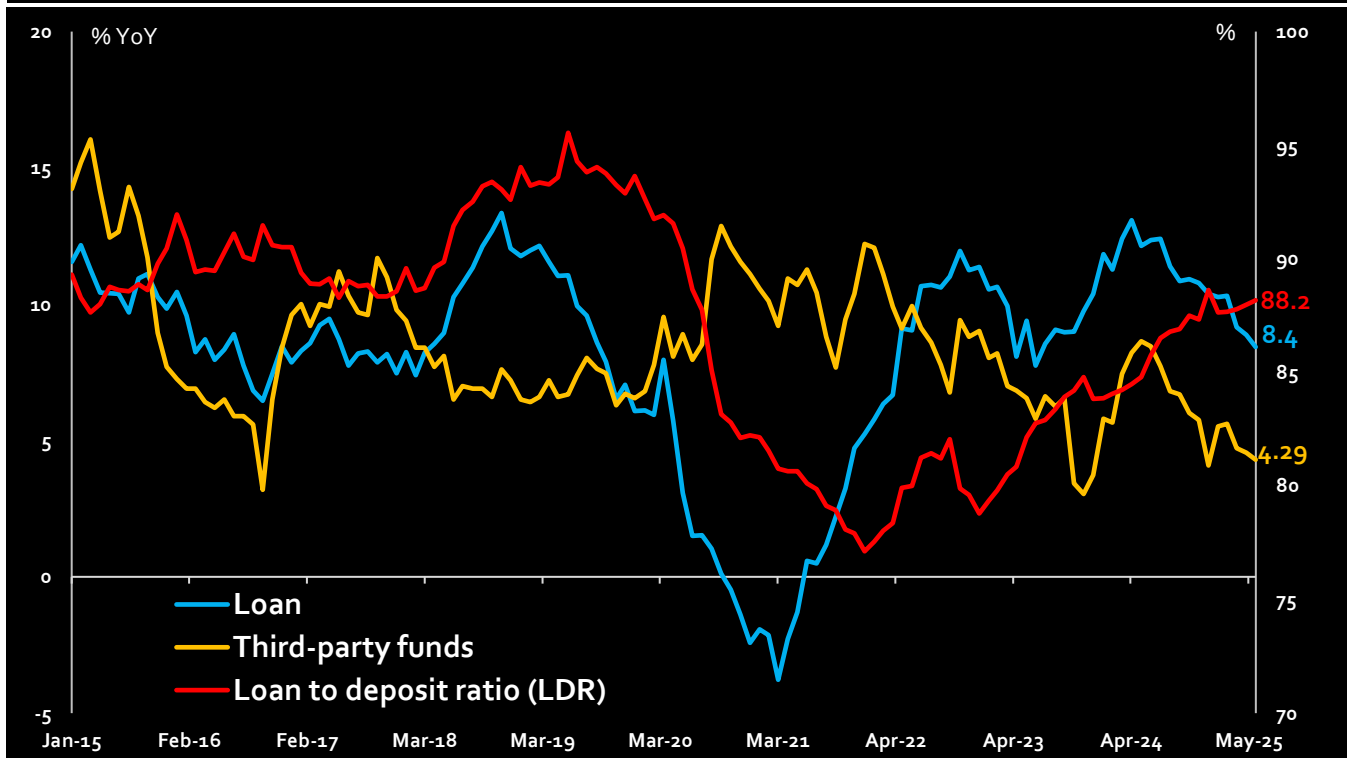
Source: BI, Bloomberg, BCA Economist

Panel 2. Banks are leading the way in driving the demand for SBN, as worsening credit quality discourage the banking sector to expand their loan portfolio



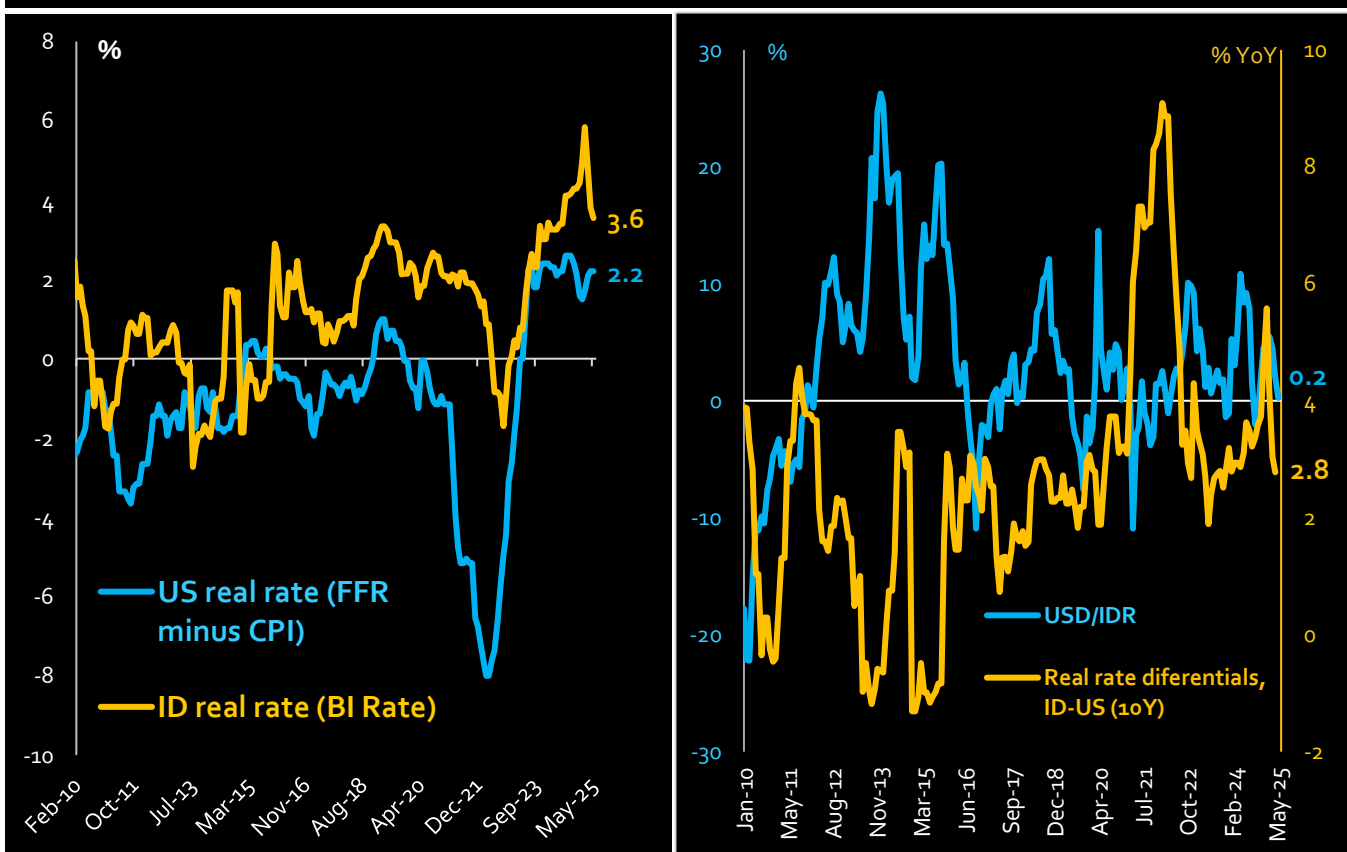
Source: MoF, BI, Bloomberg, BCA Economist

Panel 3. Rising cost of funds and worsening credit quality impede banks' ability to expand their loan portfolio



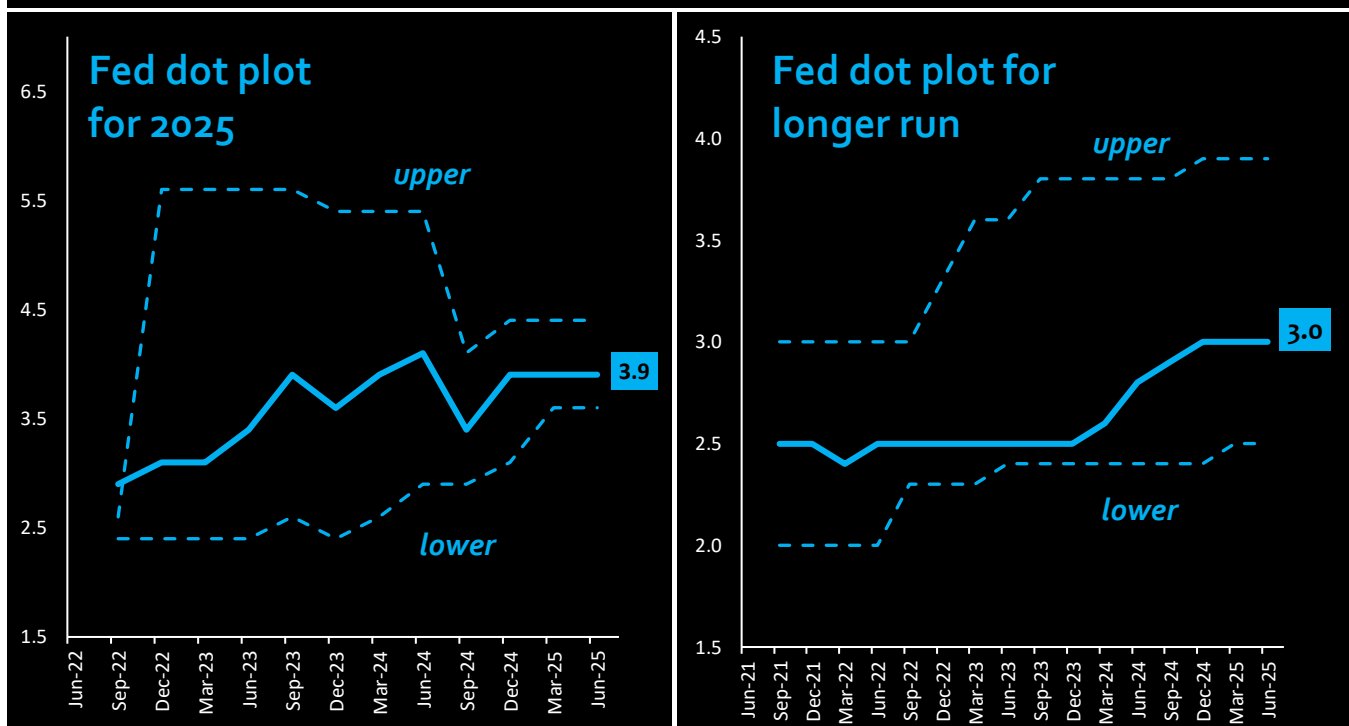
Source: MoF, Bloomberg, BCA Economist

Panel 4. The ID-US real rate differentials continue to narrow, but it might be wiser to maintain a balanced view as the SBN yield continue to be suppressed by non-market factors



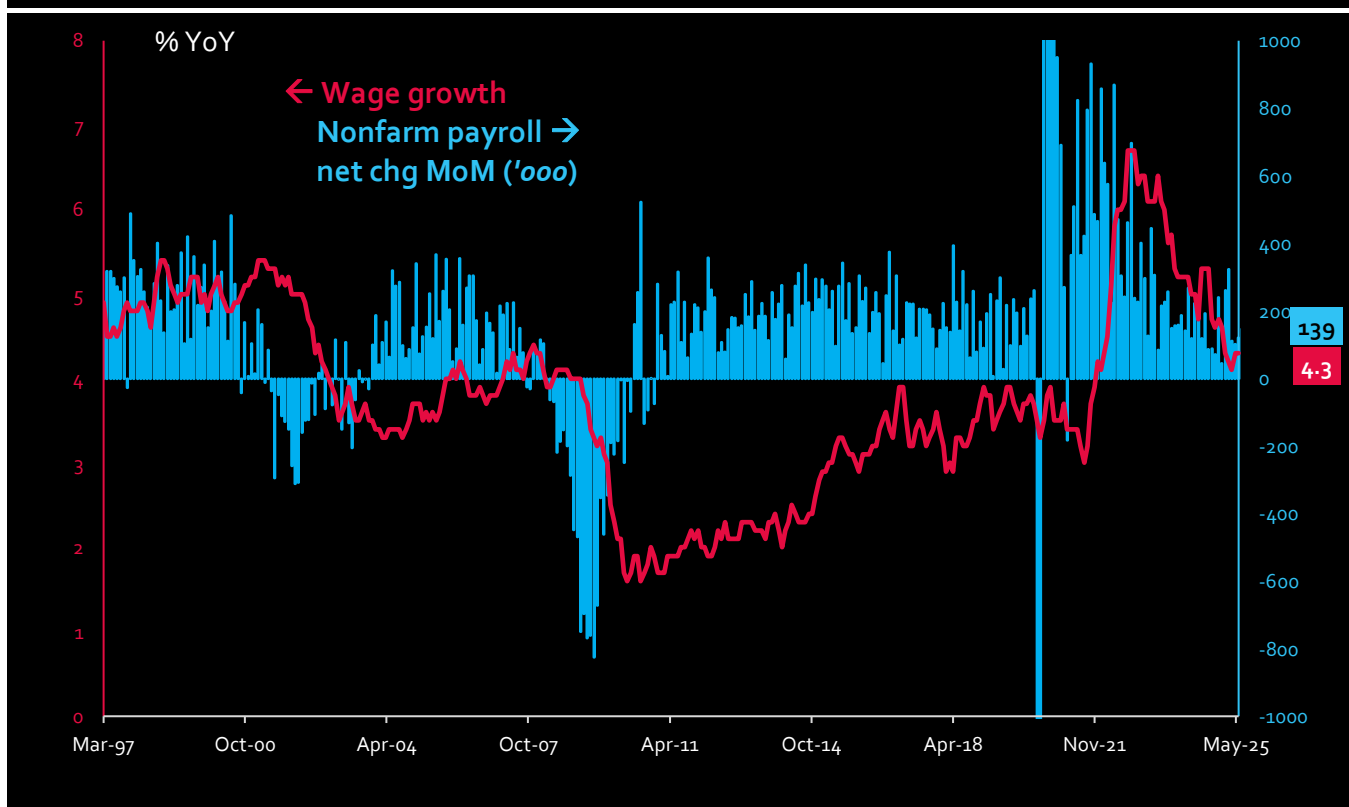
Source: BI, Bloomberg, BCA Economist

Panel 1. Stagflation risks compel the Fed to downwardly adjust their rate cut signal, with some FOMC officials did not see any rate cut at all in 2025



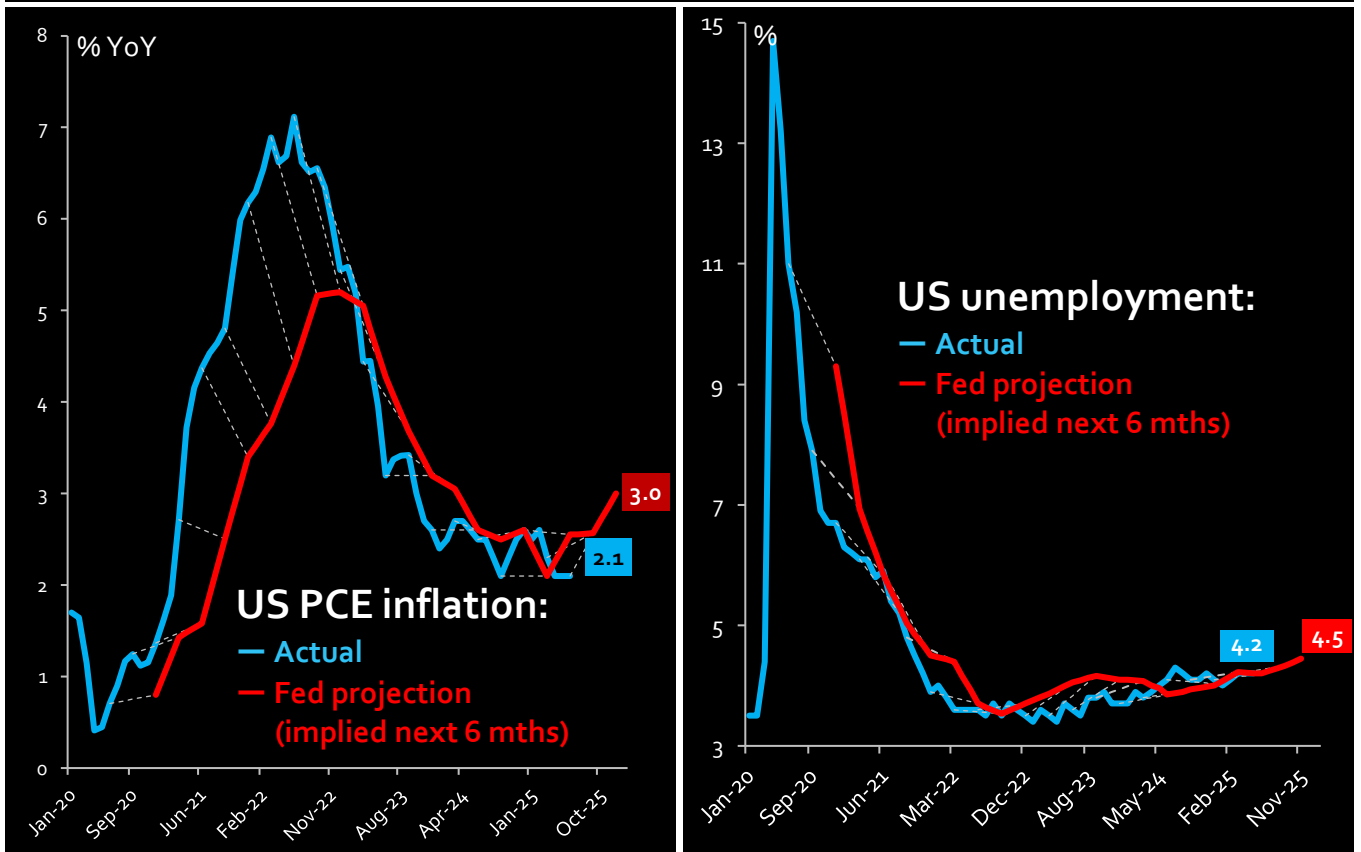
Source: Federal Reserve

Chart 1. Rather than the labour market, the galloping US import tariffs is more of a concern for the Fed



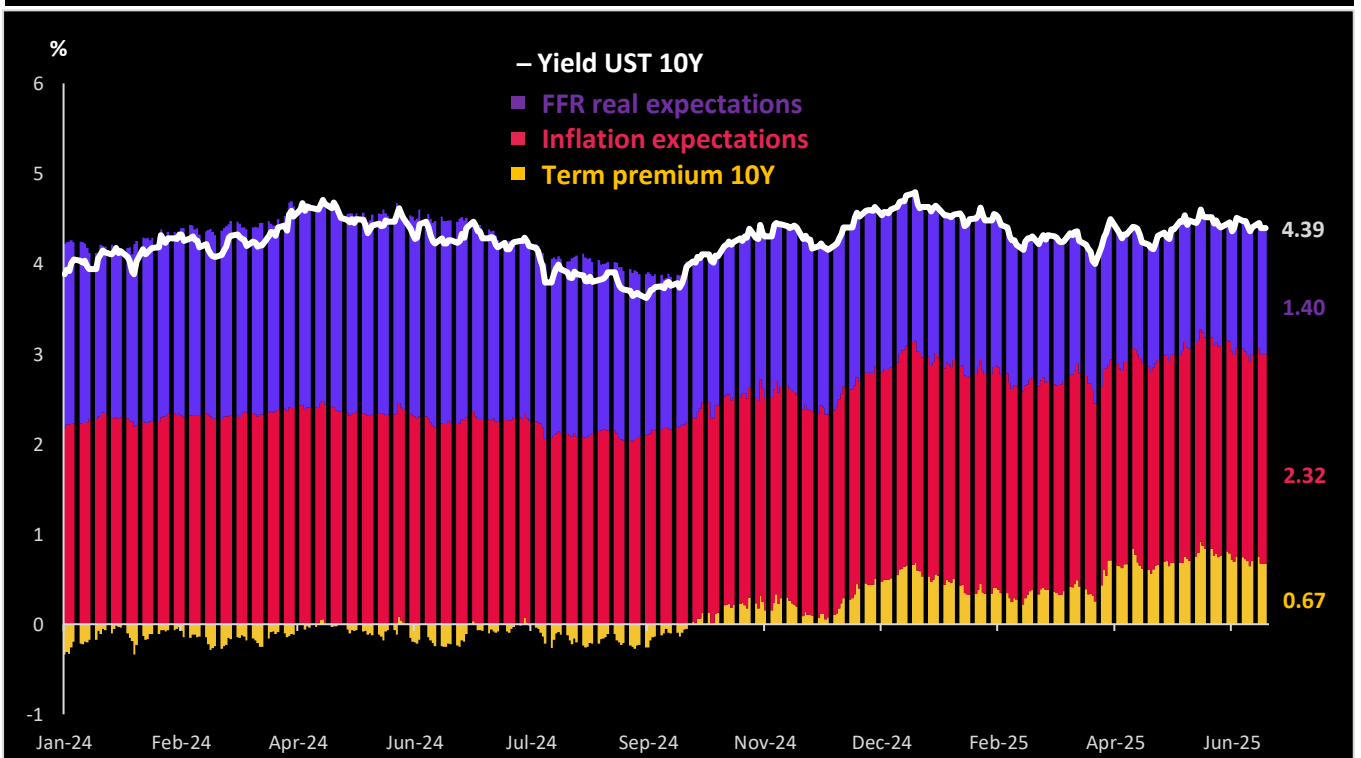
Source: US BLS, Bloomberg

Panel 2. The Fed is preparing for a sharp rise in inflationary pressures as higher oil prices may combine with tariffs to push prices northward



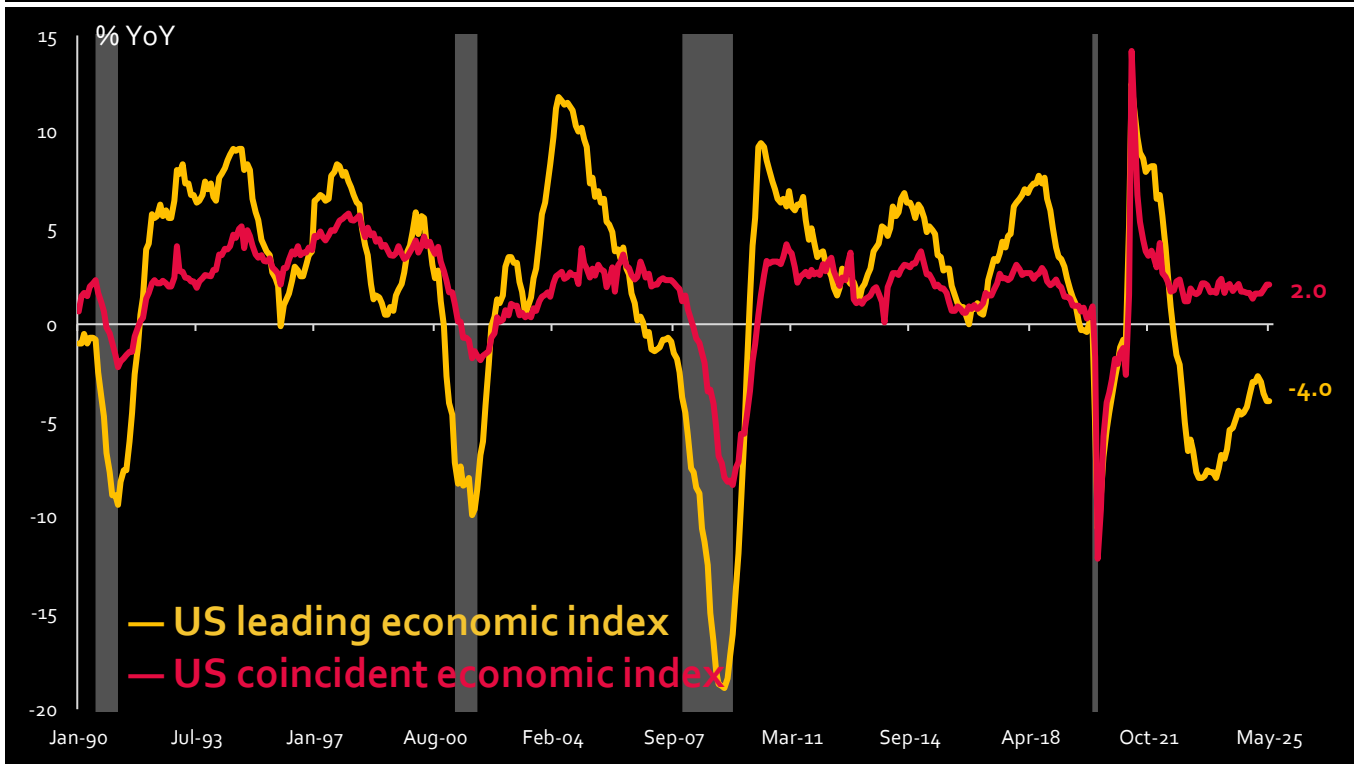
Source: Bloomberg, Federal Reserve

Chart 2. The returning inflation expectation and supply risks may keep the benchmark UST yield elevated



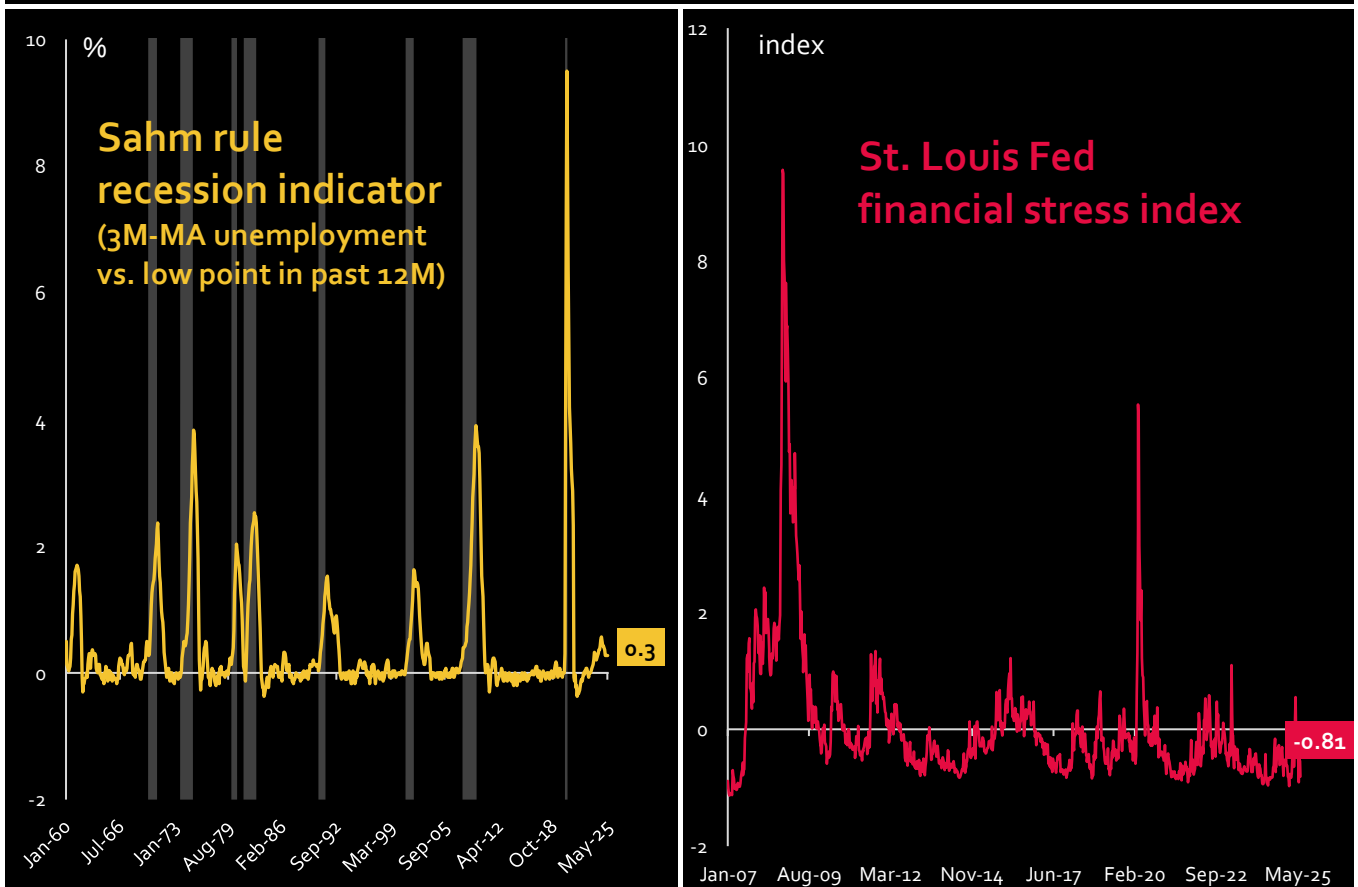
Source: Bloomberg, calculations by BCA Economist

Chart 3. Recession fears are creeping in in the US, thanks to tariff-related disruptions



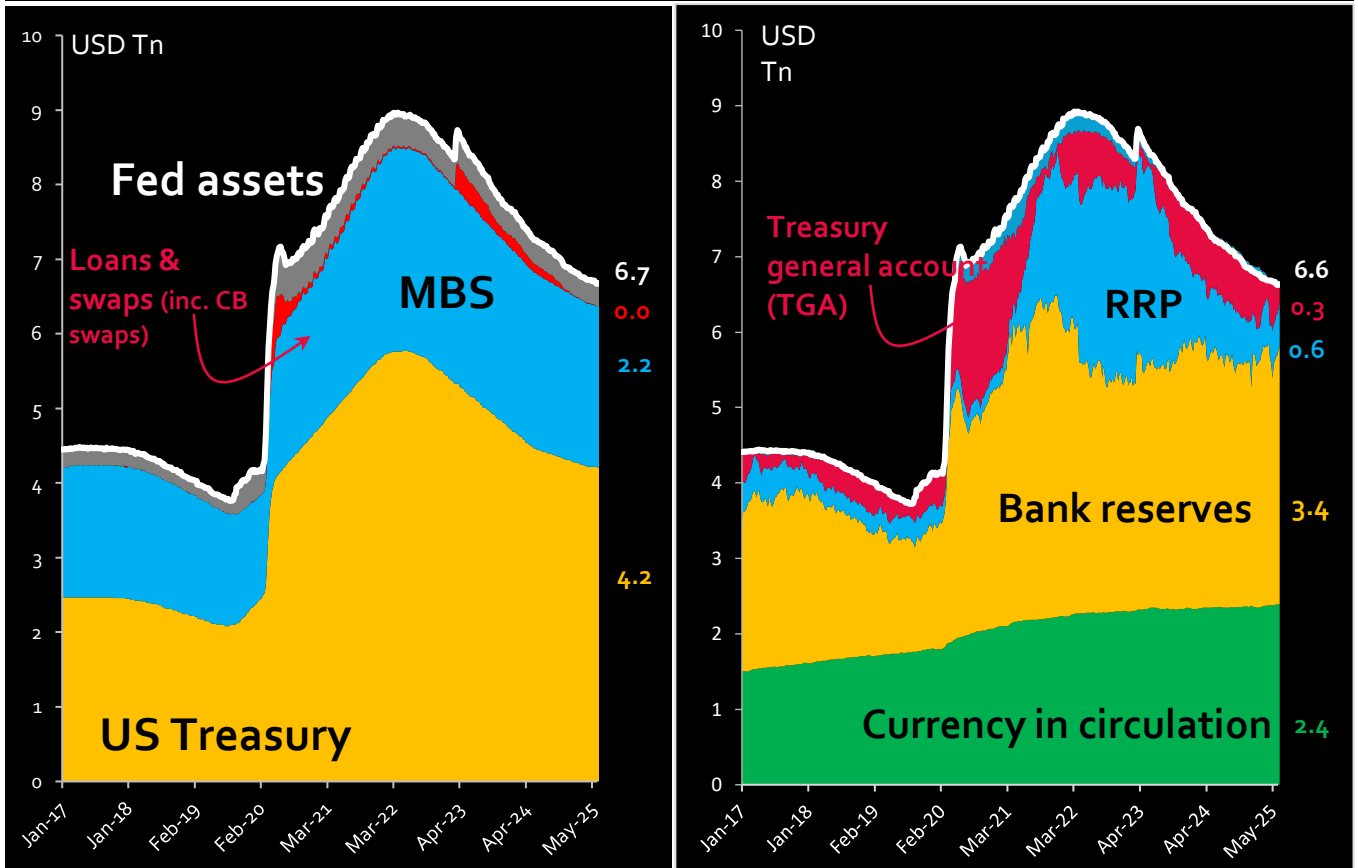
Source: Conference Board

Panel 3. Signs of impending recession are rising together with inflation expectations



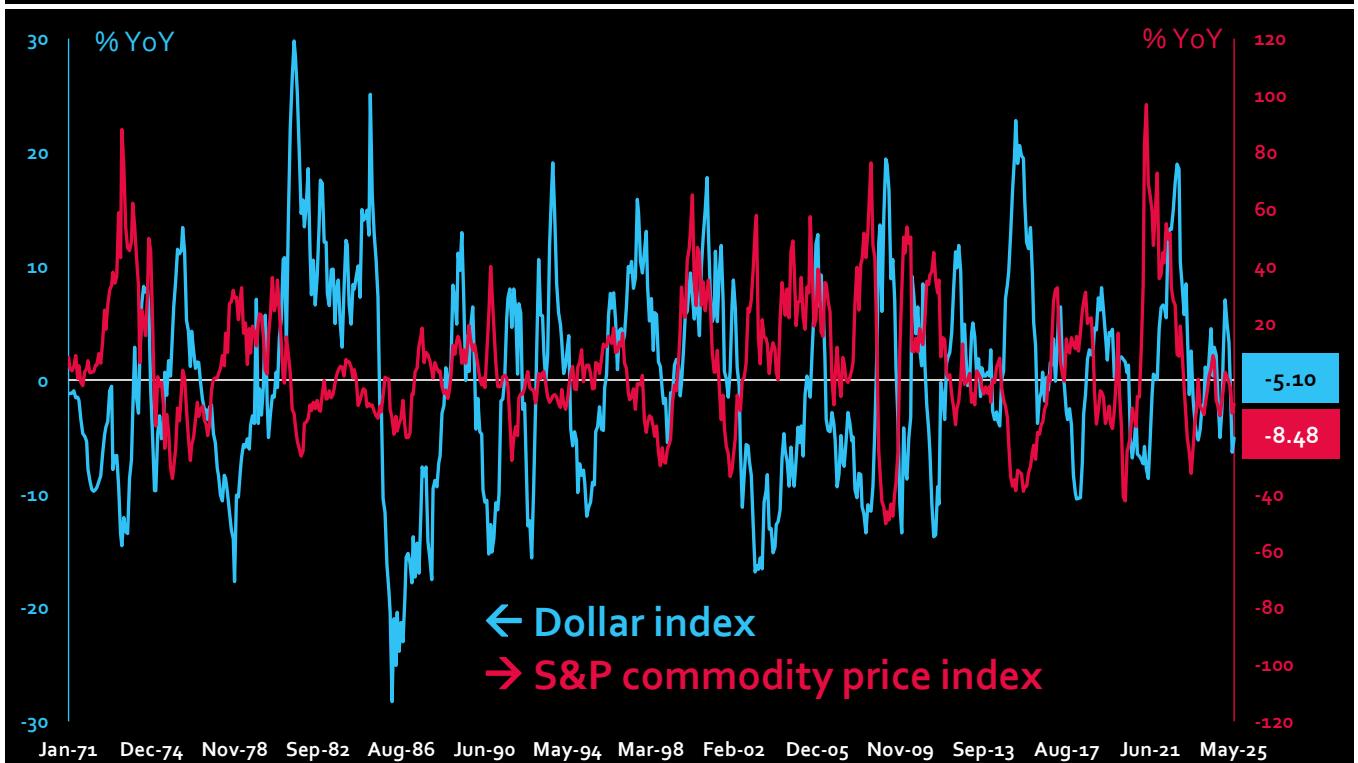
Source: St. Louis Fed

Panel 4. The dwindling TGA balance may adds the urgency for the US government to sign its budget bill into law



Source: St. Louis Fed

Chart 4. The USD is slowly moving out of its peak, but the global commodity market remains soft due to slowing manufacturing activities in China



Source: Bloomberg

Selected Macroeconomic Indicators

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	18-Jun	-1 mth	Chg (%)
US	4.50	Dec-24	2.10	Baltic Dry Index	1,874.0	1,388.0	35.0
UK	4.25	May-25	0.85	S&P GSCI Index	581.4	533.1	9.1
EU	2.15	Jun-25	0.25	Oil (Brent, \$/bbl)	76.7	65.4	17.3
Japan	0.50	Jan-25	-3.10	Coal (\$/MT)	112.0	104.4	7.2
China (lending)	2.00	Sep-24	4.45	Gas (\$/MMBtu)	3.43	3.03	13.2
Korea	2.50	May-25	0.60	Gold (\$/oz.)	3,369.4	3,203.7	5.2
India	5.50	Jun-25	2.68	Copper (\$/MT)	9,761.5	9,479.0	3.0
Indonesia	5.50	May-25	3.90	Nickel (\$/MT)	14,849.7	15,454.4	-3.9
Money Mkt Rates	18-Jun	-1 mth	Chg (bps)	CPO (\$/MT)	959.3	907.0	5.8
				Rubber (\$/kg)	1.68	1.77	-5.1
SPN (1Y)	5.98	6.19	-21.4	External Sector	Apr	Mar	Chg (%)
SUN (10Y)	6.71	6.87	-15.7	Export (\$ bn)	20.74	23.25	-10.77
INDONIA (O/N, Rp)	5.20	5.86	-66.1	Import (\$ bn)	20.59	18.92	8.80
JIBOR 1M (Rp)	6.16	6.38	-22.6	Trade bal. (\$ bn)	0.16	4.33	-96.33
Bank Rates (Rp)	Mar	Feb	Chg (bps)	Central bank reserves (\$ bn)*	152.5	157.1	-2.94
Lending (WC)	8.66	8.67	-0.75	Prompt Indicators	May	Apr	Mar
Deposit 1M	5.01	5.02	-0.47	Consumer confidence index (CCI)	117.5	121.7	121.1
Savings	0.68	0.68	0.16	Car sales (%YoY)	-15.1	5.0	-5.1
Currency/USD	18-Jun	-1 mth	Chg (%)	Motorcycle sales (%YoY)	-0.1	-3.0	-7.2
UK Pound	0.745	0.753	1.05	Manufacturing PMI	May	Apr	Chg (bps)
Euro	0.871	0.896	2.84	USA	52.0	50.2	180
Japanese Yen	145.1	145.7	0.39	Eurozone	49.4	49.0	40
Chinese RMB	7.190	7.214	0.34	Japan	49.4	48.7	70
Indonesia Rupiah	16,300	16,440	0.86	China	48.3	50.4	-210
Capital Mkt	18-Jun	-1 mth	Chg (%)	Korea	47.7	47.5	20
JCI	7,107.8	7,106.5	0.02	Indonesia	47.4	46.7	70
DJIA	42,171.7	42,654.7	-1.13				
FTSE	8,843.5	8,684.6	1.83				
Nikkei 225	38,885.2	37,753.7	3.00				
Hang Seng	23,710.7	23,345.1	1.57				
Foreign portfolio ownership (Rp Tn)	May	Apr	Chg (Rp Tn)				
Stock	3,435.7	3,244.2	191.47				
Govt. Bond	926.3	995.6	-69.37				
Corp. Bond	5.2	5.1	0.08				

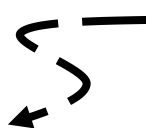
Source: Bloomberg, BI, BPS

Notes:

*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

	2019	2020	2021	2022	2023	2024	2025E
Real GDP growth (% YoY)	5.0	-2.1	3.7	5.3	5.0	5.0	4.8
Nominal GDP growth (% YoY)	6.7	-2.5	9.9	15.4	6.7	6.0	5.7
GDP per capita (USD)	4175	3912	4350	4784	4920	4960	4996
CPI inflation (% YoY)	2.7	1.7	1.9	5.5	2.6	1.6	2.0
BI Rate (%)	5.00	3.75	3.50	5.50	6.00	6.00	5.00
SBN 10Y yield (%)	7.04	5.86	6.36	6.92	6.45	6.97	7.02
USD/IDR exchange rate (average)	14,141	14,529	14,297	14,874	15,248	15,841	16,350
USD/IDR exchange rate (end of year)	13,866	14,050	14,262	15,568	15,397	16,102	16,625
Trade balance (USD Bn)	-3.2	21.7	35.3	54.5	37.0	31.0	26.0
Current account balance (% of GDP)	-2.7	-0.4	0.3	1.0	-0.1	-0.6	-1.0

Notes:

USD/IDR exchange rate projections are for fundamental values; market values may diverge significantly at any moment in time

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