

BI Policy:

A show of confidence

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Executive Summary

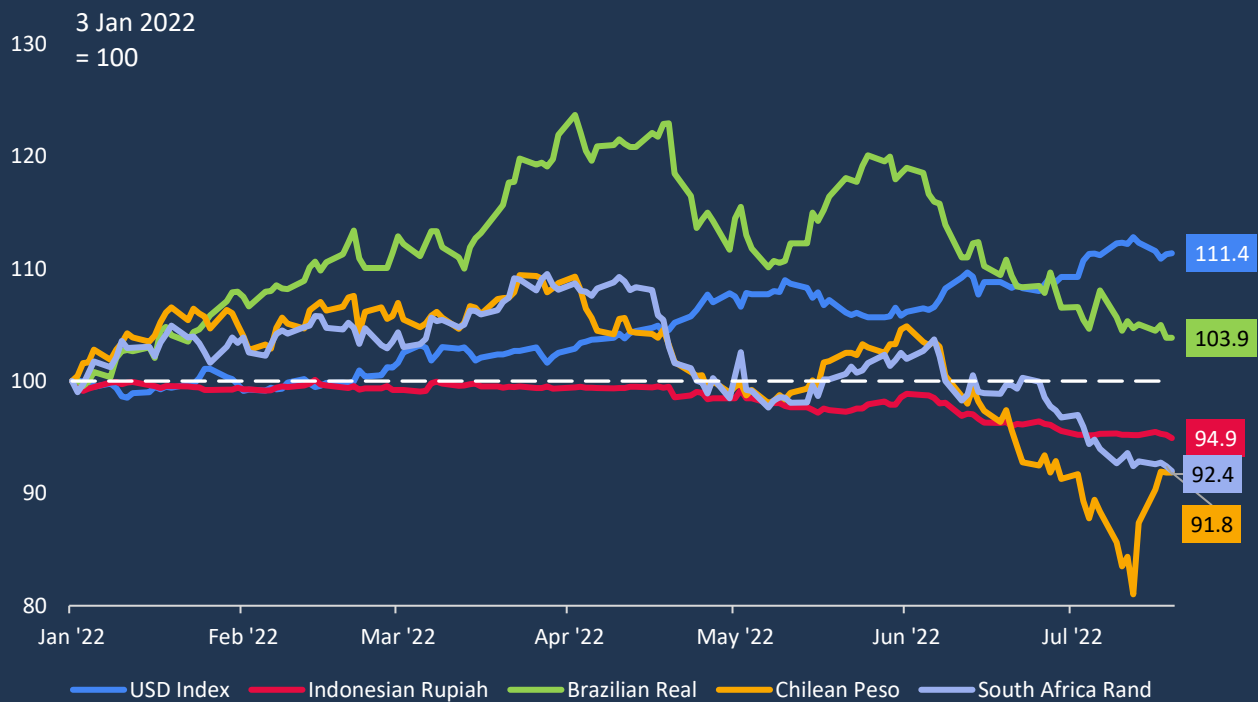
- The BI 7DRR stood at 3.50%, consistent with BI's pro-growth policy outlook. BI will rely on a more active intervention in the FX market to maintain the IDR's stability
 - Robust exports and FX reserves position due to persistently high coal prices adds to BI's confidence. However, normalising commodity prices and domestic foreign exchange supply risks would limit the extent to which BI could actively intervene in the FX market.
 - More limited adjustments to the BI 7DRR (75 – 125 bps) would still be necessary for the remainder of the year to provide BI with a more direct tool to keep the IDR's stability in check.
- Bank Indonesia maintained its 7-Day Reverse Repo Rate (BI 7DRR) at 3.50%, consistent with its growth-friendly policy outlook. BI policy thus continued to swim against the tide, diverging even further from the Fed and many other emerging market central banks' trajectory. By keeping its policy rate despite the watershed surprise rate hikes at neighbouring central banks, BI appears to be leaning towards a scenario where monetary authorities around the globe will soon need to start doctoring weak demand, again.
 - BI's decision to keep the policy rate at its record low level for the 17th month is not without its rationale. Core inflation is far from alarming and the IDR continue to show resilience compared to its peers. The IDR also continues to show resilience relative to its peers, with the central bank promising some measures of intervention in the FX market to avoid the IDR to slide even further amidst the proliferation of external risks.
 - Alas, there's a limit to how the central bank could stay true to its promise to intervene. First, the prospect of rising imports in line with recovering domestic demand plus the substantial external debt payments would stretch the availability of hard currencies, while low-interest rates on foreign savings accounts would not help in ensuring hard currencies gained from exports would stay within the domestic economy. Further complicating the matter is the darkening outlook on the commodity market. Despite early gains derived from supernormal commodity profits, some commodity-exporting countries have seen their currencies losing ground against the USD as commodity prices start to move down the hill (**Chart 1**), a scenario that also looms over the IDR.
 - There's probably an argument to be made that the persistently high coal prices would allow BI to continuously tap into its exports-driven FX reserves arsenal. But despite high demand

from new markets in Europe, putting all of the eggs in this scenario would be unjustifiably risky. There's no telling whether Indonesian coal producers could satisfy the demand from their European buyers, while the zero-COVID policy also makes demand from China hard to predict.

- Although a policy rate hike is yet to be seen, BI's fight against external risks has finally come in the form of a gradual sell-off of government bonds in its balance sheet, an important move given BI's uncharacteristic presence in the domestic bond market (**Chart 2**). This policy would further increase Indonesian government bonds' yield, especially in the short term, given that higher RRR have insofar limit banks' presence in the domestic bond market while foreign investors are still unwilling to return to emerging bond markets amid global uncertainty. Such an increase in yield, however, could finally attract banks to make a comeback in the domestic bond market – slowing down liquidity creation in the financial sector as banks are torn between lending and increasingly attractive bond yields.
- However, one might question the allure of BI's decision to start selling government bonds it bought at the height of the pandemic, considering the not-so-direct route the policy would take in keeping the IDR's value from sliding further southbound. Per our previous reports, EM currencies' exchange rate is more correlated with the real policy rate (inflation minus O/N rate) rather than longer-term rates.
- The theoretical (and statistically proven) relationship between real policy rates and exchange rate provides a rationale for some measures of policy rate hikes down the road, especially as inflationary pressures are expected to continue to flare up. A higher policy rate could add strength to the IDR, alleviating pressures from imported inflation that would maintain consumers' spending power, an instrumental part of Indonesia's economic growth engine. It is with this in mind that we maintain our call that adjustments to the BI 7DRR may still be in the cards this year. However, today's lack of adjustments shall trim the upper range of our rate hike expectations as rate hikes to the tune of 75 – 125 bps seems more likely at this point.

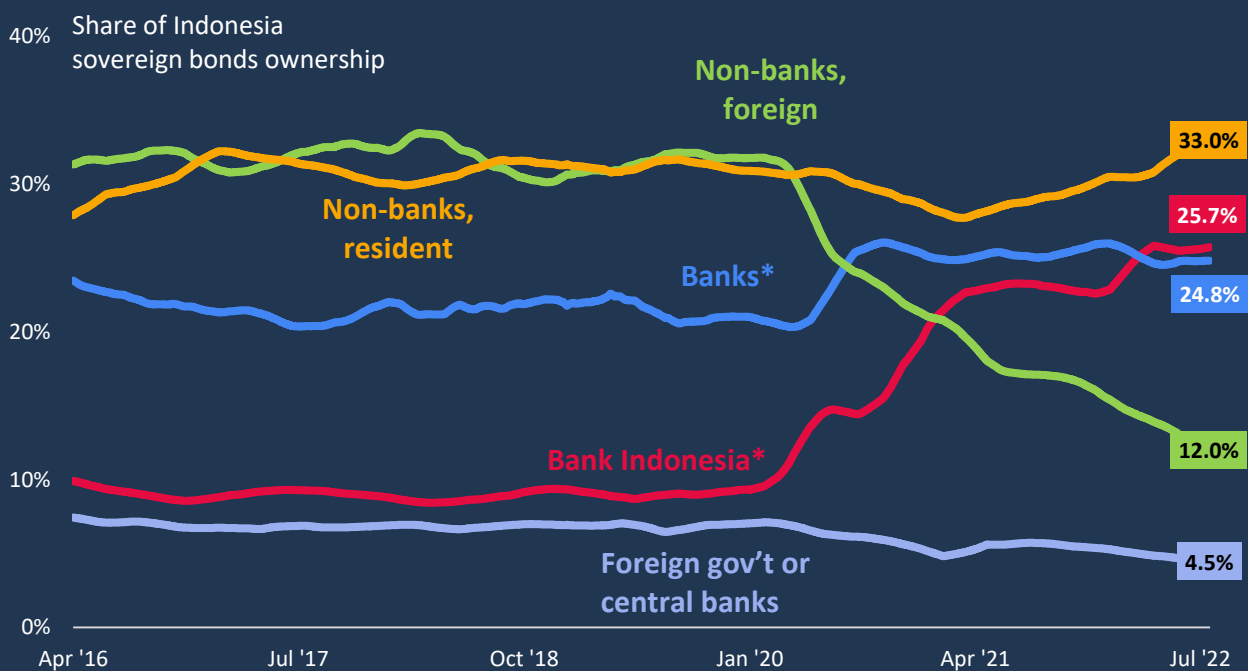
"Some commodity-exporting countries have seen their currencies losing ground against the USD as commodity prices start to move down the hill"

Chart 1. The currency appreciation story comes to an end in many commodity-exporting countries as commodity prices have started to recede.



Source: Bloomberg

Chart 2. Banks could make a comeback in the domestic bond market as BI's departure may lead to a more attractive yield



*Bonds used in monetary operations are deducted from banks and included in Bank Indonesia's accounts

Source: MoF, calculations by BCA Economist

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	20-Jul	-1 mth	Chg (%)
US	1.75	Jun-22	-7.35	Baltic Dry Index	2,113.0	2,578.0	-18.0
UK	1.25	Jun-22	-8.15	S&P GSCI Index	681.9	753.6	-9.5
EU	0.00	Mar-16	-8.60	Oil (Brent, \$/bbl)	106.9	113.1	-5.5
Japan	-0.10	Jan-16	-2.60	Coal (\$/MT)	372.7	334.4	11.4
China (lending)	4.35	Oct-15	1.85	Gas (\$/MMBtu)	7.58	7.32	3.6
Korea	2.25	Jul-22	-3.75	Gold (\$/oz.)	1,696.6	1,839.4	-7.8
India	4.90	Jun-22	-2.11	Copper (\$/MT)	7,358.0	8,967.0	-17.9
Indonesia	3.50	Feb-21	-0.85	Nickel (\$/MT)	21,129.3	25,581.0	-17.4
Money Mkt Rates	20-Jul	-1 mth	Chg (bps)	CPO (\$/MT)	889.0	1,297.5	-31.5
				Rubber (\$/kg)	1.55	1.59	-2.5
SPN (1M)	2.94	2.35	59.2	External Sector	Jun	May	Chg (%)
SUN (10Y)	7.45	7.46	-0.9				
INDONIA (O/N, Rp)	2.80	2.79	0.3	Export (\$ bn)	26.09	21.51	21.3
JIBOR 1M (Rp)	3.55	3.54	0.6	Import (\$ bn)	21.00	18.61	12.9
Bank Rates (Rp)	Mar	Feb	Chg (bps)	Trade bal. (\$ bn)	5.09	2.90	
				Central bank reserves (\$ bn)*	136.4	135.6	0.63
Lending (WC)	8.59	8.62	-2.97	Prompt Indicators	Jun	May	Apr
Deposit 1M	2.85	2.85	0.57				
Savings	0.63	0.63	-0.23				
Currency/USD	20-Jul	-1 mth	Chg (%)	Consumer confidence index (CCI)	128.2	128.9	113.1
UK Pound	0.835	0.817	-2.19				
Euro	0.982	0.952	-3.04	Car sales (%YoY)	8.9	-9.8	5.0
Japanese Yen	138.2	135.0	-2.31				
Chinese RMB	6.756	6.717	-0.58	Motorcycle sales (%YoY)	-30.9	-2.5	-7.1
Indonesia Rupiah	14,988	14,823	-1.10				
Capital Mkt	20-Jul	-1 mth	Chg (%)	Cement sales (%YoY)	#N/A	7.6	-10.0
JCI	6,874.7	6,937.0	-0.90	Manufacturing PMI	Jun	May	Chg (bps)
DJIA	31,874.8	29,888.8	6.64				
FTSE	7,264.3	7,016.3	3.54	USA	53.0	56.1	-310
Nikkei 225	27,680.3	25,963.0	6.61	Eurozone	52.1	54.6	-250
Hang Seng	20,890.2	21,075.0	-0.88	Japan	52.7	53.3	-60
Foreign portfolio ownership (Rp Tn)	Jun	May	Chg (Rp Tn)	China	51.7	48.1	360
				Korea	51.3	51.8	-50
Stock	2,388.2	2,503.9	-115.73	Indonesia	50.2	50.8	-60
Govt. Bond	780.2	795.7	-15.51				
Corp. Bond	17.9	18.1	-0.16				

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

Indonesia – Economic Indicators Projection

	2017	2018	2019	2020	2021	2022E
Gross Domestic Product (% YoY)	5.1	5.2	5.0	-2.1	3.7	4.8
GDP per Capita (US\$)	3877	3927	4175	3912	4350	4615
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	4.7
BI 7 day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	4.50
USD/IDR Exchange Rate (end of year)**	13,433	14,390	13,866	14,050	14,262	15,070
Trade Balance (US\$ billion)	11.8	-8.5	-3.2	21.7	35.3	39.2
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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