

FX Reserves:

A crucial deterrent amid global slowdown

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Executive Summary

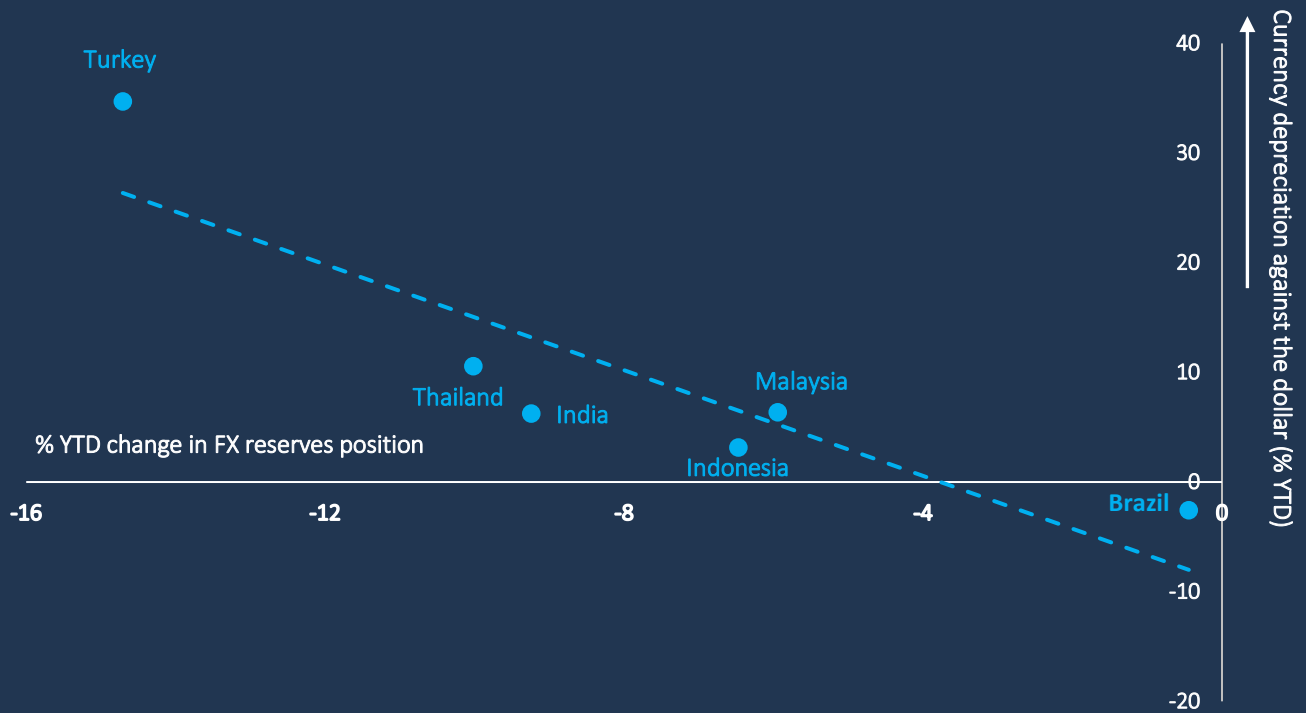
- Bank Indonesia's FX reserves stood at USD 132.2 Bn at the end of July 2022, a decrease of USD 4.2 Bn from the previous month's figures.
- BI's FX interventions might not be sustainable to stabilize the Rupiah since FX reserves is arguably more useful as a deterrent rather than an actual resource to be tapped to fight exchange rate pressures.
- At the same time, domestic liquidity is tightening due to falling commodity prices and increasing domestic FX demand.
- Since spending FX reserves may not be sustainable over the long-haul, it appears that BI may still need to pull out the big gun – BI7DRR hike – to prevent further Rupiah depreciation by the end of the year.

- Bank Indonesia's FX reserves stood at USD 132.2 Bn at the end of July 2022, a decrease of USD 4.2 Bn from the previous month's figures. This decline was driven, as before, by the need to stabilize the Rupiah amid intensifying capital outflow risks, but unlike before, there was no global bond issuance in this particular month to offset the FX outflows.
- BI's FX interventions, along with robust coal prices, have been key in stabilizing the Rupiah amid the generalized weakness in emerging currencies. However, we argue that this is not a sustainable strategy in the medium term, as FX reserves is arguably more useful as a deterrent rather than an actual resource to be tapped to fight exchange rate pressures (**Chart 1**). Indeed, declining FX reserve coverage (in relation to foreign portfolio ownership) is correlated with Rupiah depreciation in the year ahead.
- Furthermore, FX liquidity at home is clearly becoming tighter, as reflected in the decline of banks' placements in BI's FX instruments (**Chart 2**). On the one hand, part of this decline serves as a good sign since it shows just how robust domestic demand for imports have been, both for consumption and investment. But on the flip side, the fall in banks' placements in BI amid high export earnings suggests that exporters are unwilling to repatriate some of their FX earnings back home due to higher short-term interest rates abroad.
- The decline in banks' FX placements can also be exacerbated by falling prices for some of Indonesia's export mainstays. While part of this decline in earnings could potentially be offset by the increasing demand for coal from some European countries, Indonesia might not be

able to fully benefit from this opportunity due to the fact that the type of coal it usually exports to China is different than the higher-calorie coal needed in European power plants. At the same time, China's demand for coal might be slowing down amid general economic softening as well as robust domestic production growth. As such, we expect that Indonesia's trade balance would continue to be in surplus, but perhaps not as large as H1-22.

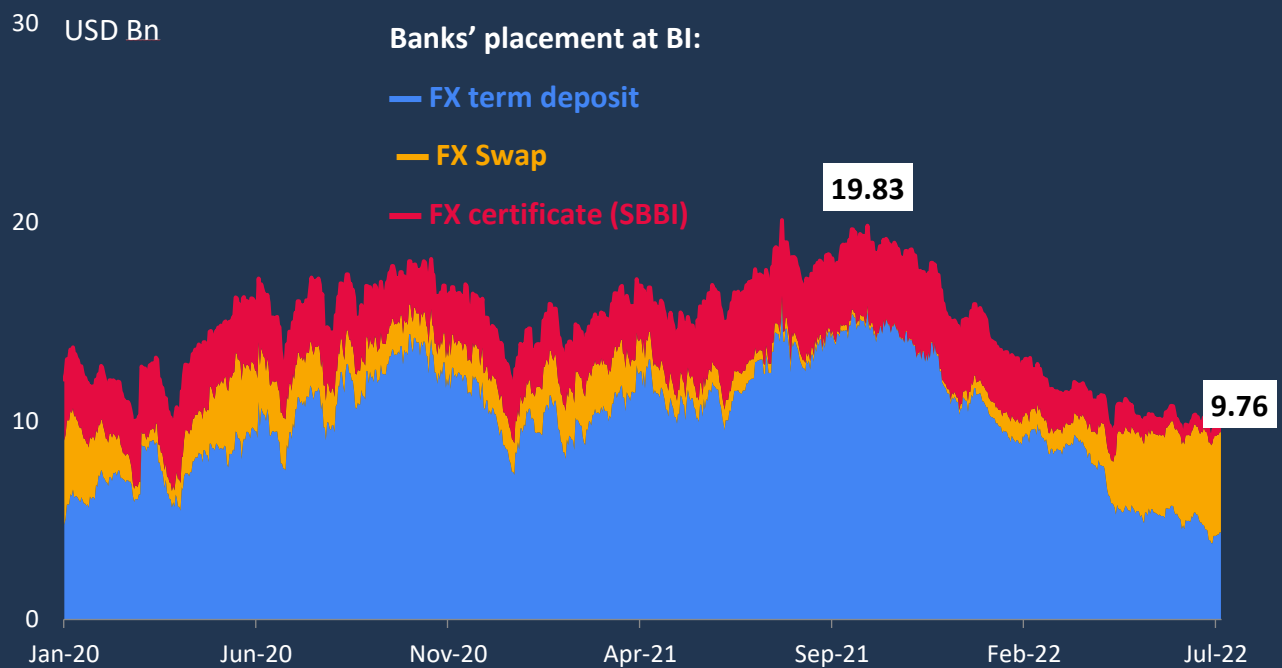
- While domestic FX liquidity is weakening, demand for FX have remained strong, if not more so, in recent months. Indeed, banks experienced double-digit FX loan growth in the first half of 2022, driven by companies in the mining and manufacturing (smelter) sector, which are keen to expand their production amid strong prices in H1-22. Another source of FX demand was Pertamina, which needed liquidity to sustain imports as current oil pricing structure means that they continue to sell at a loss.
- Since spending FX reserves may not be sustainable over the long-haul, it appears that BI may still need to pull out the big gun – BI7DRR hike – to prevent further Rupiah depreciation by the end of the year. Granted, the recent rally of stock and bond markets may make such move feel superfluous in August, as pressure on the Rupiah has softened. But we should be careful not to let the rally lull us into false complacency, as it by itself could be quite misleading.
- First of all, there is no guarantee that the Fed would slow the pace of tightening if the US inflation remains high, even if a (shallow) recession were to happen. In recent days, we have seen several Fed officials talking up the possibility of further hikes, perhaps to cool down speculations that it would soon pivot its policy. We also note that the yield curve is typically a predictor of future recession (in 2-3 quarters time), and that the US recession in H1-22 might not be a true recession as domestic demand was still strong, at least in Q1. In other words, the worst is yet to come, and it may bring further market turbulence with it.
- We also note that even with the recent rebound in the bond and equity markets, net inflows into Indonesia's bond market remains very limited. The rally, it seems, has not translated into significantly stronger sentiment towards emerging markets as an asset class, and so the challenge of potential outflows remain. Furthermore, weaker commodity prices could also spell trouble for Indonesian equities, especially considering that the commodity boom was a big driver of foreign equity inflows in the first place.

Chart 1. FX reserves can likely have a deterrent effect against currency depreciation



Source: Bloomberg, BCA Research Team

Chart 2. Banks' placements in BI's FX instruments have declined amid tighter domestic FX liquidity



Source: BI

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	4-Aug	-1 mth	Chg (%)
US	2.50	Jul-22	-6.60	Baltic Dry Index	1,603.0	2,159.0	-25.8
UK	1.25	Jun-22	-8.15	S&P GSCI Index	649.5	719.7	-9.8
EU	0.50	Jul-22	-8.40	Oil (Brent, \$/bbl)	94.1	113.5	-17.1
Japan	-0.10	Jan-16	-2.50	Coal (\$/MT)	365.0	381.3	-4.3
China (lending)	4.35	Oct-15	1.85	Gas (\$/MMBtu)	8.39	5.65	48.5
Korea	2.25	Jul-22	-4.05	Gold (\$/oz.)	1,791.3	1,808.2	-0.9
India	5.40	Jul-22	-1.61	Copper (\$/MT)	7,720.2	7,998.5	-3.5
Indonesia	3.50	Feb-21	-1.44	Nickel (\$/MT)	22,137.0	22,447.0	-1.4
Money Mkt Rates	4-Aug	-1 mth	Chg (bps)	CPO (\$/MT)	885.9	1,065.2	-16.8
				Rubber (\$/kg)	1.51	1.62	-6.8
SPN (1M)	2.47	1.87	59.3	External Sector	Jun	May	Chg (%)
SUN (10Y)	7.20	7.26	-6.7				
INDONIA (O/N, Rp)	2.80	2.78	1.9	Export (\$ bn)	26.09	21.51	21.3
JIBOR 1M (Rp)	3.75	3.54	21.0	Import (\$ bn)	21.00	18.61	12.9
Bank Rates (Rp)	Apr	Mar	Chg (bps)	Trade bal. (\$ bn)	5.09	2.90	
				Central bank reserves (\$ bn)*	132.2	135.6	-2.47
Lending (WC)	8.49	8.59	-10.53	Prompt Indicators	Jun	May	Apr
Deposit 1M	2.84	2.85	-1.17				
Savings	0.62	0.63	-0.57				
Currency/USD	4-Aug	-1 mth	Chg (%)	Consumer confidence index (CCI)	128.2	128.9	113.1
UK Pound	0.822	0.825	0.35				
Euro	0.976	0.960	-1.69	Car sales (%YoY)	8.9	-9.8	5.0
Japanese Yen	132.9	135.6	2.05				
Chinese RMB	6.749	6.701	-0.72	Motorcycle sales (%YoY)	-30.9	-2.5	-7.1
Indonesia Rupiah	14,933	14,968	0.23				
				Cement sales (%YoY)	#N/A	7.6	-10.0
Capital Mkt	4-Aug	-1 mth	Chg (%)				
JCI	7,057.3	6,639.2	6.30	Manufacturing PMI	Jul	Jun	Chg (bps)
DJIA	32,726.8	31,097.3	5.24				
FTSE	7,448.1	7,232.7	2.98	USA	52.8	53.0	-20
Nikkei 225	27,932.2	26,153.8	6.80	Eurozone	49.8	52.1	-230
Hang Seng	20,174.0	21,830.4	-7.59	Japan	52.1	52.7	-60
Foreign portfolio ownership (Rp Tn)	Jul	Jun	Chg (Rp Tn)	China	50.4	51.7	-130
				Korea	49.8	51.3	-150
Stock	2,442.4	2,388.2	54.28	Indonesia	51.3	50.2	110
Govt. Bond	751.2	780.2	-28.98				
Corp. Bond	16.7	17.9	-1.14				

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	5.1
GDP per Capita (US\$)	3877	3927	4175	3912	4350	4564
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	5.2
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	36.9
Current Account Balance (% GDP)	-1.6	-3.0	-2.7	-0.4	0.3	0.5

** Estimation of Rupiah's fundamental exchange rate

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