

BI Policy:

A prelude to further tightening

Lazuardin Thariq H.
Economist/Analyst

Barra Kukuh Mamia
Senior Economist

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Executive Summary

- Bank Indonesia increased the BI 7DRR by 25-bps to 3.75% as the central bank moved to anticipate the impending increase in subsidised fuel prices.
- Upward adjustment to subsidised fuel prices would translate to higher inflation, which may exacerbate depreciation risks due to narrowing real rate return on Rupiah-denominated assets.
- BI may not be too hawkish in its outlook as higher inflation would threaten domestic consumption while narrowing fiscal space and receding commodity prices would limit other outlets of economic growth.

- Bank Indonesia finally moved from its position among interest rate laggards, having decided to hike its policy rate (BI 7DRR) by 25bps to 3.75%. BI's decision to shelve its record low policy rate of 3.50% came after the recent fiscal-side surprise, where the skyrocketing fuel subsidies bill prompted the government to send signals of upward price adjustment for subsidised fuels.
- BI's official statement clearly stated that the decision to raise interest rates had been strategically taken to mitigate the risk of impending adjustment on subsidised fuel prices, which would translate to a higher headline CPI figure. The recent increase in the policy rate is also broadly consistent with BI's guidance, especially regarding its repeated statement on core inflation. Recovering domestic demand has consistently given strength to core inflation, which last month edged closer to 3% and is largely expected to continue up north. Per our previous report on the July CPI figure, the transition from commodity-driven inflation to core inflation would invite some reaction from BI as monetary tools would be more efficient in combating core inflation than foodstuffs-driven inflation. Depending on the scale of the fuel price adjustment, we could expect the headline inflation to reach 6.2 – 6.8% in the coming months, which may translate to further policy adjustments in the short term.
- While inflation risks due to fiscal-side pressure have startled the gun on policy rate hikes, exchange rate considerations may also continue to influence BI's policy decision going forward. The prospect of increasing domestic inflationary pressures would effectively narrow the real return on Rupiah-denominated financial assets, providing no incentive for foreign investors to find their way back to the domestic market. Receding commodity prices due to slowing global economic activity (more on this later) may also reduce the attractiveness of the domestic stock market, exacerbating capital outflow risks which may wipe out the recent inflows to domestic financial markets.
- Equally concerning is the prospect of long-term US inflation. Although last month's US CPI reading shows that the normalisation of commodity prices has begun to bog down US inflation, more

evidence reveals that high inflation may be structural rather than a one-time event. For one, lower post-pandemic job participation in the US may continue to fuel the wage-price inflation spiral. The global supply would also remain highly uncertain, considering that the rift between the Sino-Russia bloc and the western-led bloc appears to be widening. Indeed, some in the market have abandoned the expectation that the Fed will start speaking dovishly following the increasingly apparent economic downturn in the US, fueling the speculation that tight monetary policies would remain throughout the following year (**Chart 1**). This double trouble of narrowing real return and continued strengthening of the USD will add pressure for the IDR to depreciate, which may encourage BI to deliver more interest rate hikes throughout the rest of the year.

- Indeed, a series of back-door liquidity policies have succeeded in reducing excess liquidity from the financial system (**Chart 2**), and the 25-bps rate hike would further help BI's liquidity-draining campaign. BI, however, may not afford to be too hawkish considering the darkening prospects for the global and domestic economy in the periods ahead. For

"The prospect of increasing domestic inflationary pressures would effectively narrow the real return on Rupiah-denominated financial assets"

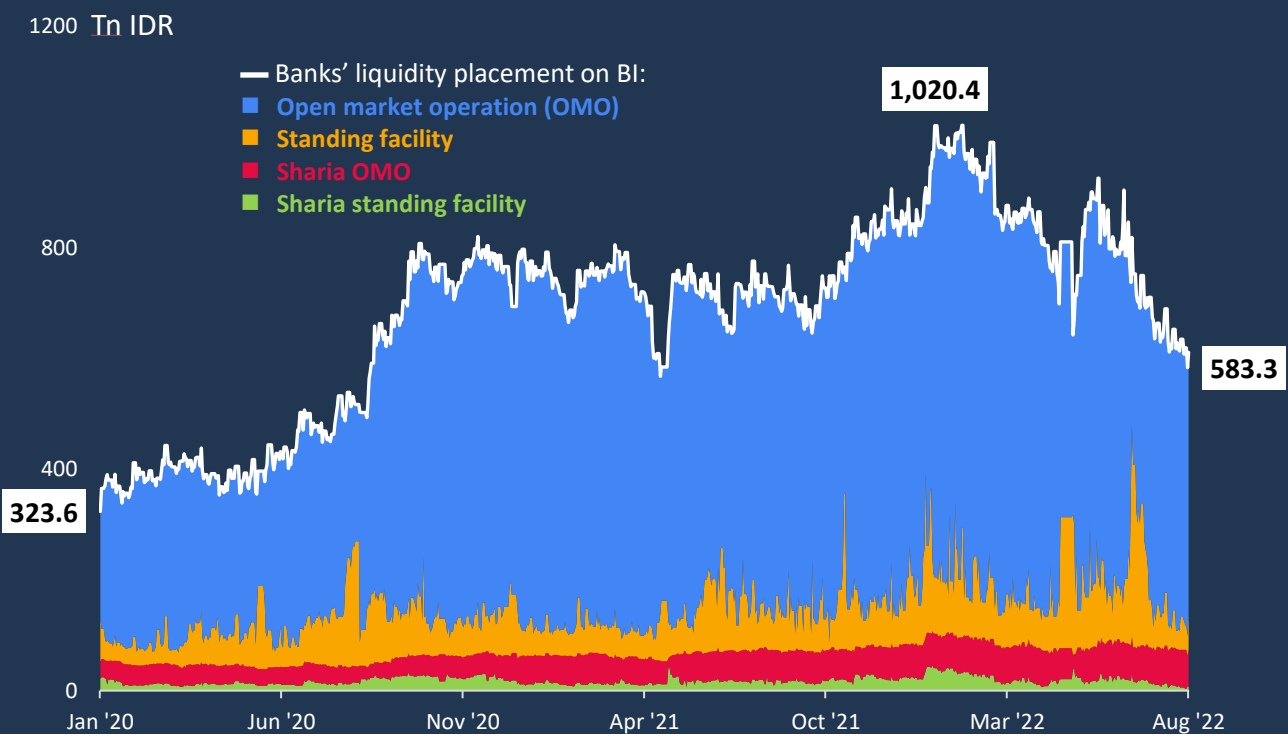
one, anaemic global demand would lower commodity prices, limiting the extent to which net exports could contribute to domestic economic growth. Lower commodity prices may also limit liquidity flowing to the domestic private sector, reducing domestic corporate sectors' appetite to expand. Meanwhile, the government is set to deliver higher social spending amid a darkening global outlook in 2023, sacrificing spending on capital goods and infrastructure projects. Upward adjustments to subsidised fuel prices would further hit the prospect of consumption at the time when domestic consumption is increasingly relied upon in the effort to hit next year's 5.3% economic growth target.

- The need to maintain an accommodative policy is well captured in the recent announcement on the RRR incentives scheme, which may not be as limiting as first thought. RRR incentives through compliance with the so-called inclusive financing ratio (RPIM) apply to a wide range of sectors (46 sectors in total), indicating a central bank that is still well in the mood from credit expansion. While monetary expansion is indeed a source of concern, continued loan growth may still benefit the domestic economy, given that liquidity from the commodity windfall remains "locked" in a handful of commodity-exporting sectors.
- Prospects of long-term strengthening of the US Dollar amid falling commodity prices (while energy prices remain relatively high due to uncertain supplies) are likely to complicate BI's policy considerations in 2023. Without its outsized trade surplus, adjustments to the BI 7DRR are what is left for BI to protect the IDR's value against the much stronger USD. At the same time, hawkish policies would jeopardise domestic consumption, which is essentially Indonesia's trump card in achieving the somewhat optimistic growth target in 2023. Pressures are mounting for BI to strike a balance between growth-accommodating and exchange rate-stabilising policies. Further hikes in the remainder of 2022 then, seems to be the most plausible scenario for now.

Chart 1. The Fed's policy rate is expected to remain high given the prospect of a more structural inflation in the US



Chart 2. Banks' liquidity dwindles relatively quickly in line with BI's liquidity-draining campaign while loan disbursement continue to grow



Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	23-Aug	-1 mth	Chg (%)
US	2.50	Jul-22	-6.00	Baltic Dry Index	1,271.0	2,146.0	-40.8
UK	1.25	Jun-22	-8.85	S&P GSCI Index	684.9	663.4	3.2
EU	0.50	Jul-22	-8.40	Oil (Brent, \$/bbl)	100.2	103.2	-2.9
Japan	-0.10	Jan-16	-2.70	Coal (\$/MT)	425.0	386.0	10.1
China (lending)	4.35	Oct-15	1.65	Gas (\$/MMBtu)	9.75	8.10	20.4
Korea	2.25	Jul-22	-4.05	Gold (\$/oz.)	1,748.2	1,727.6	1.2
India	5.40	Aug-22	-1.31	Copper (\$/MT)	8,170.8	7,433.0	9.9
Indonesia	3.75	Aug-22	-1.19	Nickel (\$/MT)	21,656.3	22,080.0	-1.9
				CPO (\$/MT)	929.8	858.5	8.3
				Rubber (\$/kg)	1.45	1.54	-5.8
Money Mkt Rates	23-Aug	-1 mth	Chg (bps)				
SPN (1M)	1.98	2.14	-16.3	External Sector	Jul	Jun	Chg (%)
SUN (10Y)	7.10	7.47	-36.6	Export (\$ bn)	25.57	26.15	-2.2
INDONIA (O/N, Rp)	2.84	2.79	5.1	Import (\$ bn)	21.35	21.00	1.6
JIBOR 1M (Rp)	3.80	3.55	25.3	Trade bal. (\$ bn)	4.23	5.15	
Bank Rates (Rp)	Apr	Mar	Chg (bps)	Central bank reserves (\$ bn)*	132.2	136.4	-3.06
Lending (WC)	8.49	8.59	-10.53	Prompt Indicators	Jul	Jun	May
Deposit 1M	2.84	2.85	-1.17	Consumer confidence index (CCI)	123.2	128.2	128.9
Savings	0.62	0.63	-0.57	Car sales (%YoY)	29.4	8.5	-9.3
Currency/USD	23-Aug	-1 mth	Chg (%)	Motorcycle sales (%YoY)	-13.3	-30.9	-2.5
UK Pound	0.845	0.833	-1.36	Cement sales (%YoY)	#N/A	-41.1	7.6
Euro	1.003	0.979	-2.38				
Japanese Yen	136.8	136.1	-0.48				
Chinese RMB	6.835	6.752	-1.22				
Indonesia Rupiah	14,838	15,018	1.21				
Capital Mkt	23-Aug	-1 mth	Chg (%)	Manufacturing PMI	Jul	Jun	Chg (bps)
JCI	7,163.3	6,887.0	4.01	USA	52.8	53.0	-20
DJIA	32,909.6	31,899.3	3.17	Eurozone	49.8	52.1	-230
FTSE	7,488.1	7,276.4	2.91	Japan	52.1	52.7	-60
Nikkei 225	28,452.8	27,914.7	1.93	China	50.4	51.7	-130
Hang Seng	19,503.3	20,609.1	-5.37	Korea	49.8	51.3	-150
Foreign portfolio ownership (Rp Tn)	Jul	Jun	Chg (Rp Tn)	Indonesia	51.3	50.2	110
Stock	2,442.4	2,388.2	54.28				
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

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

Livia Angelica Thamsir

Economist / Analyst

livia_thamsir@bca.co.id

+6221 2358 8000 Ext: 1069933

Ahmad Aprilian Rizki

Research Assistant

ahmad_rizki@bca.co.id

+6221 2358 8000 Ext: 20378

Agus Salim Hardjodinato

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

Lazuardin Thariq Hamzah

Economist / Analyst

lazuardin_hamzah@bca.co.id

+6221 2358 8000 Ext: 1071724

Arief Darmawan

Research Assistant

arief_darmawan@bca.co.id

+6221 2358 8000 Ext: 20364

Barra Kukuh Mamia

Senior Economist

barra_mamia@bca.co.id

+6221 2358 8000 Ext: 1053819

Suryaputra Wijaksana

Economist / Analyst

suryaputra_wijaksana@bca.co.id

+6221 2358 8000 Ext: 1065752

Keely Julia Hasim

Economist / Analyst

keely_hasim@bca.co.id

+6221 2358 8000 Ext: 1071535

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

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