

Yen and now

15 May 2023

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Summary

- The “Fed pivot” sentiment continues to add strength onto the Indonesian financial market. However, the worsening earnings outlook sparks an outflow in the stock market while Indonesian bonds appear to have reached their ceiling.
 - Bank of Japan announced its readiness to lift the yield curve control (YCC) policy last week, although the announcement come with strict conditions. The termination of the YCC policy may harm Asian markets, although its impact on Indonesia may be limited given the still-low foreign capital stocks
 - The termination of the YCC policy may spark a sell-off in the UST market, adding to the IDR’s value as the USD dwindle. However, the prospect of narrowing real rate differential in such a scenario means that Bank Indonesia’s path towards policy easing remains limited.
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- Inflation data for the world’s two largest economies were released last week, which portends slowing demand on both sides of the Pacific. China’s inflation fell to 0.1% in April 2023, the weakest since February 2021 as China continues to struggle with anaemic domestic demand amidst an unresolved crisis in the property sector. Meanwhile, US inflation falls below 5% for the first time since April 2021, with energy prices providing a negative contribution to the headline number on the back of a -5.1% annual change. Recent US inflation data should affirm that OPEC’s recent production cut is not a geopolitical manoeuvre but an economic response to the decline in the global demand for energy and goods.
 - Slowing demand in the US has increased market expectations of the Fed potentially cutting its policy rate in Q3 2023, boosting the short-term outlook for Indonesian assets. However, although this Fed pivot sentiment remains intact, foreign investors' interest in Indonesian assets seems to be diminishing, as reflected in capital outflows amounting to USD 154 million last week (USD 74.9 million from the stock market). The declining confidence seems to be related to Indonesia's reputation as a commodity-driven market. The decline in commodity prices leads to a downward revision in Indonesian companies' earnings prospects, resulting in a sell-off ahead of the commodity sector's dividend window. This earning dynamic is mostly a non-issue for the bond market. However, the domestic bond market is not full of positive upsides either, and the upward trend in Indonesian bonds throughout 2023 may have reached its limit, leaving investors to pocket their returns and look elsewhere for opportunities.

Waving goodbye to YCC with strong hearts

- Another risk that needs to be considered is the potential exit of the Bank of Japan (BoJ) from its yield curve control (YCC) policy experiment. Last week, BoJ Governor Ueda announced that the central bank would be ending its YCC policy, marking a shift in Japan's long-standing practice of maintaining an extremely accommodative monetary policy. However, this signal comes with a strict condition: the BoJ's 2% price target must be achieved in a stable and sustainable manner before the central bank would consider ending the YCC policy. Therefore, our initial task is to assess whether the current inflationary period in Japan will stabilise at a level that satisfies the BoJ's condition.
- Japan has experienced inflation surpassing the BoJ's 2% target over the past 12 months, reaching a peak of 4.3% YoY in January 2023 before stabilising around 3.2% in recent months. However, there are concerns that the current inflationary phase resembles the short-lived episode observed in 2014-2015, where a rise in VAT triggered a shopping frenzy and subsequent price hikes. And there are indeed arguments that the current bout of inflation is of a cost-push and temporary nature.
- Similar to the inflation witnessed in 2014-2015, energy-related inflation initiates the upward trend in prices, followed by volatile components that sustain elevated inflation for several months. Currently, energy inflation is no longer a significant factor in Japan, but volatile components like food (which experienced a 7.8% YoY increase in Mar-23) have become the primary drivers of price changes (see Chart 1). Alas, these food prices may start to decline as

"The current inflation in Japan exhibit different characteristics compared to previous episodes."

global food prices decrease. Furthermore, the strengthening of the JPY due to anticipation of YCC lifting and the sentiment the Fed pivot sentiment would also contribute to suppressing food prices, particularly considering Japan's reliance on imported food items such as meat and cereals. Another notable contributor to Japanese inflation is housing prices, which saw a 4.8% YoY increase in Mar-23. However, it is important to note that housing prices tend to lag behind other prices due to statistical peculiarities involved in their calculation.

- Some arguments suggest that the current inflation in Japan may exhibit different characteristics compared to previous episodes. Inflation in domestically-driven components, such as recreational spending and furniture, seems to be resilient and resistant to downward pressure, indicating a strengthening of domestic demand. Additionally, insights from recent *shunto* negotiations (spring labour-management wage negotiations) indicate that Japanese companies are actively restructuring their pay systems, which could pave the way for more substantial wage increases in the future. These developments in wages have the potential to further bolster domestic aggregate demand in the coming periods.
- The emergence of wage-driven inflationary pressure signifies a significant development in the potential lifting of the Bank of Japan's YCC policy. Our next task is to explore how the end of YCC by the BoJ may have ripple effects on economies across Asia and globally. One important aspect highlighted in Governor Ueda's recent announcement is that the BoJ intends to

shrink its balance sheet alongside ending YCC. This process may coincide with the Federal Reserve's QT and the European Central Bank's liquidity tightening, resulting in reduced global liquidity. This, in turn, could potentially exert downward pressure on stock prices across various markets (*see Chart 2*).

- An academic study supports the notion that the termination of the YCC policy could adversely affect Asian stock prices. The study by Fukuda (2019) demonstrates that the implementation of the YCC policy, which combines Quantitative and Qualitative Monetary Easing (QQE) with Negative Interest Rate Policy (NIRP) and YCC, has a positive spillover effect on Asian stocks. According to the model used in the study, a 10 basis points decline in the 10-year Japanese Government Bond (JGB) yield could lead to an increase in stock prices of up to 44.5 basis points in developed Asia markets and up to 27.6% in developing Asia markets. Building on the empirical evidence provided by Fukuda (2019), it can be inferred that the discontinuation of YCC may have a detrimental impact on stock prices, and potentially bonds, across Asia, as Japanese investors may seek to sell Asian assets in order to allocate funds to JGBs.

“The strengthening of the Japanese Yen (JPY) following the revocation of YCC could potentially have a positive impact on the value of the Indonesian Rupiah (IDR)”

- Strong interlinkages between the Japanese market and broader Asian markets, as highlighted in Fukuda (2019), suggest that Indonesian financial markets are not completely shielded from the risk of capital outflows directed towards Japan. However, the severity of the impact remains a subject of debate. One factor to consider is that Indonesia's foreign capital stock, particularly in the bond market, has not fully recovered to pre-pandemic levels (*see*

Chart 3). Additionally, the risk of capital outflows by Japanese investors is somewhat limited by the ownership of Indonesian bonds, which is predominantly held by the Japanese government's pension fund.

- A creative argument even suggests that the strengthening of the JPY following the revocation of YCC could potentially have a positive impact on the value of the IDR. This is based on the notion that improved economic prospects in influential Asian economies like Japan and China tend to create positive externalities that benefit investors in other Asian markets. Furthermore, historical data indicates a positive correlation between the movements of Asian currencies and the JPY (*see Chart 4*).

- The most compelling argument, however, revolves around the potential impact of Japan-bound capital outflows on the US market, where Japanese investors hold a more substantial role than other investors except offshore financial centres. A

potential termination to the YCC policy would spark a sell-off in the UST market by one of its most important investors, potentially resulting in a weakening USD that would consequentially lead to the strengthening of the Rupiah's value.

- Although the potential termination of YCC may not directly impact the value of the Rupiah, the resulting weakening of the USD could have implications for Bank Indonesia. A sell-off of US Treasuries by Japanese investors would lead to higher yields on these assets, narrowing the yield spread between Indonesian and US assets. While the historical correlation between the ID-US real yield spread and USDIDR exchange rate may seem to weaken given the soaring US inflation, higher yields on safer assets like US Treasuries

still pose a threat to the demand for Indonesian bonds. This could negatively impact the outlook for capital inflows that have been supporting the Rupiah in 2023. Maintaining a healthy real yield spread between Indonesian and global assets becomes crucial to provide support for the Rupiah amidst the potential volatility in Japanese investors' portfolios. This reinforces our

expectation that BI is not yet in a position to tweak its monetary policy despite the increasingly loud sirens of slowing domestic aggregate demand growth.

Chart 1

Would it be different this time?

Domestic-driven components continue to fuel Japan's inflation in 2023 despite lower energy prices, but so does in 2014.

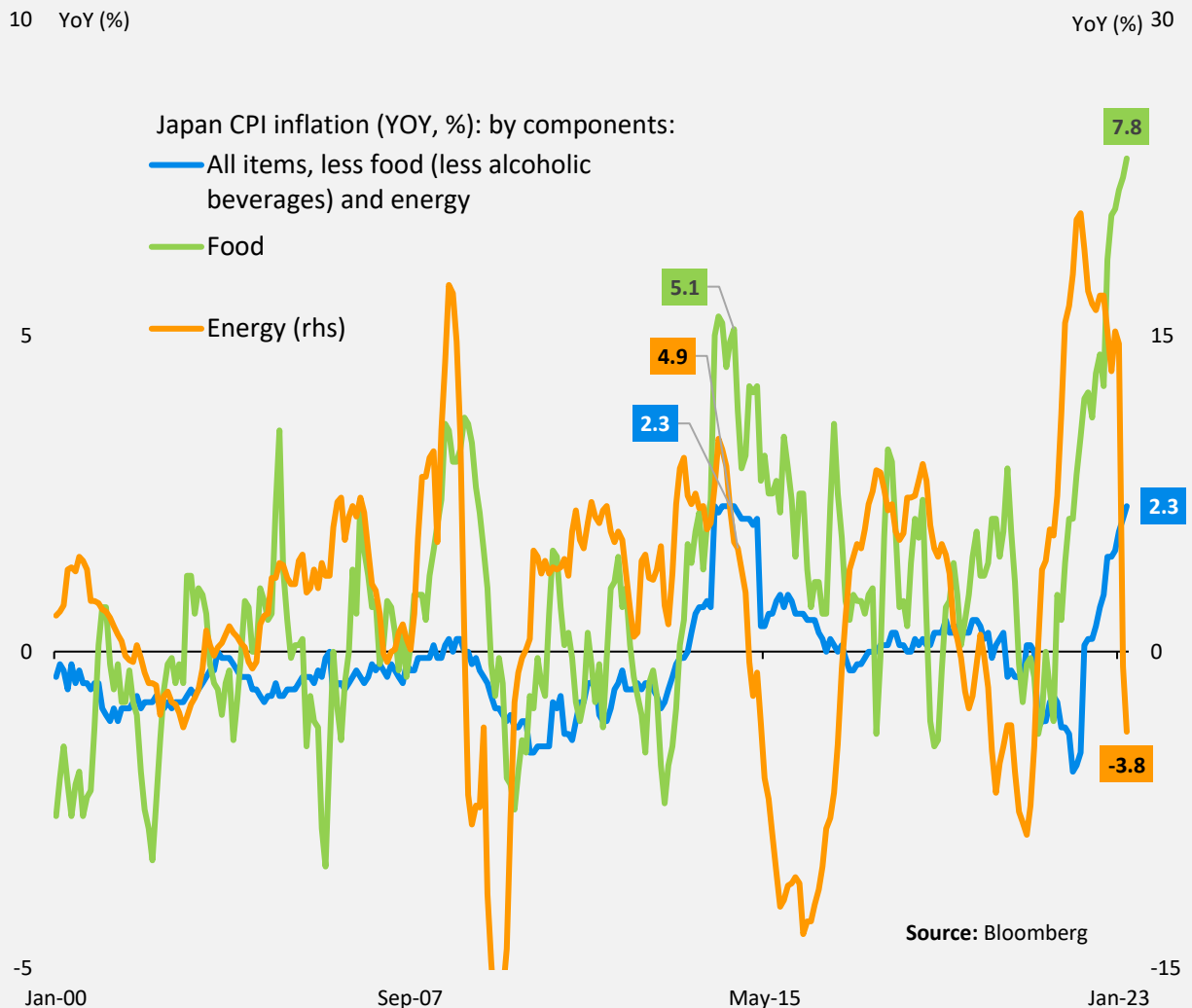


Chart 2

Getting drier

BoJ would trim its balance sheet after making an exit from YCC, further reducing global liquidity that may weigh down on stock prices

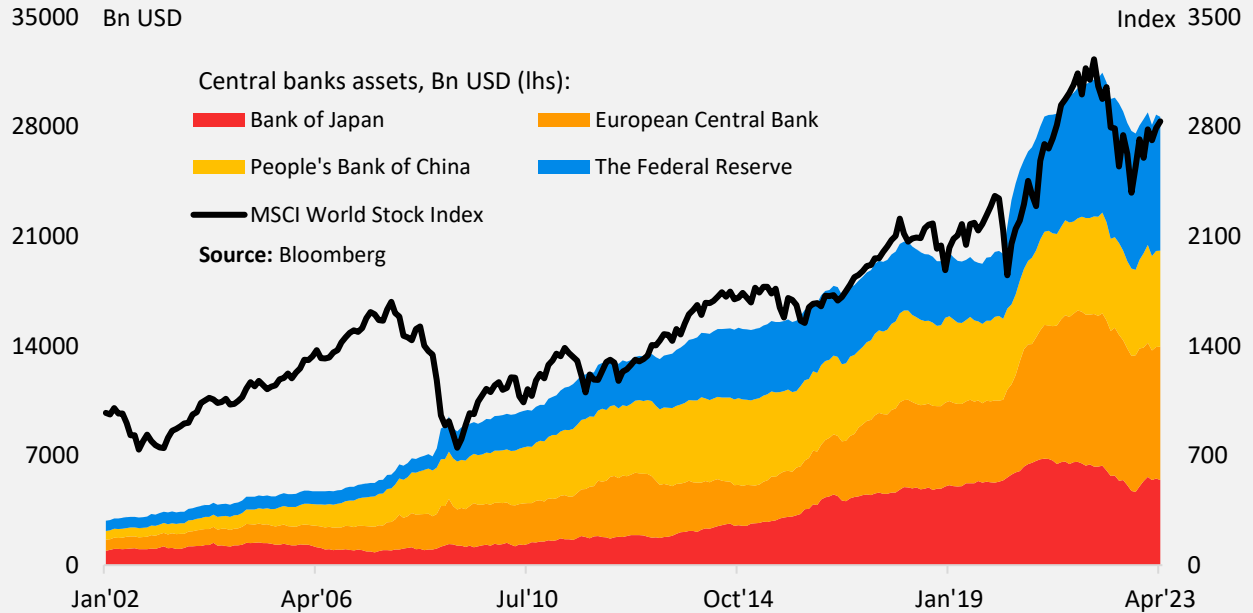


Chart 3

What's left to go?

Still-low foreign capital stock (compared to pre-COVID) limits the extent of capital outflows that may arise from a shift in Japanese investors' portfolio.

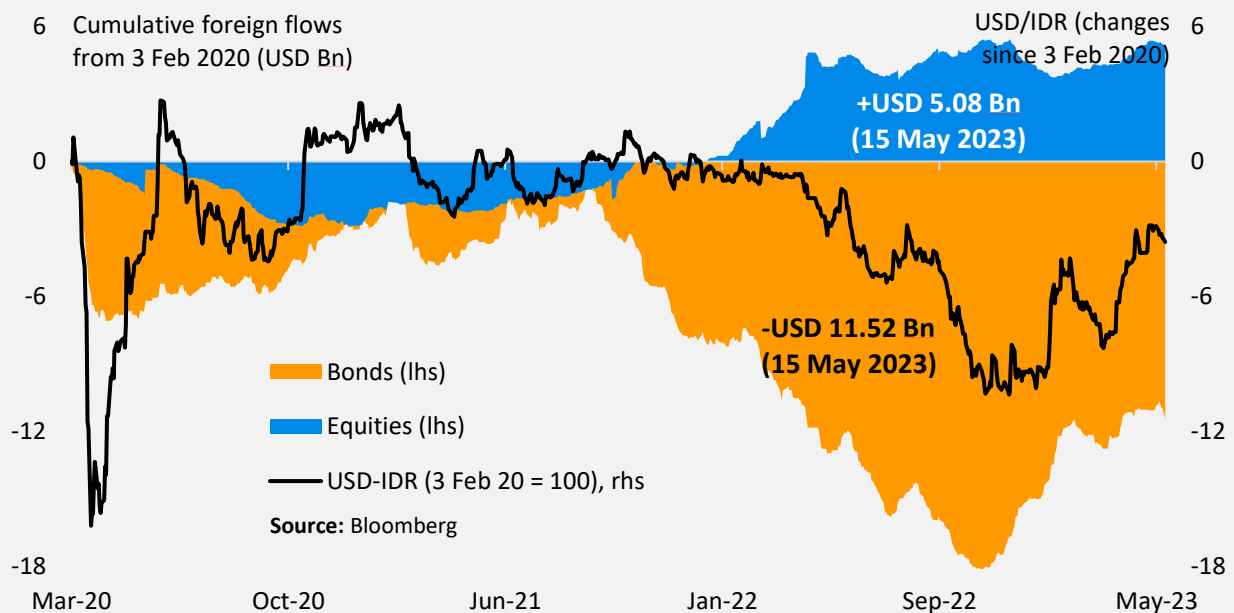
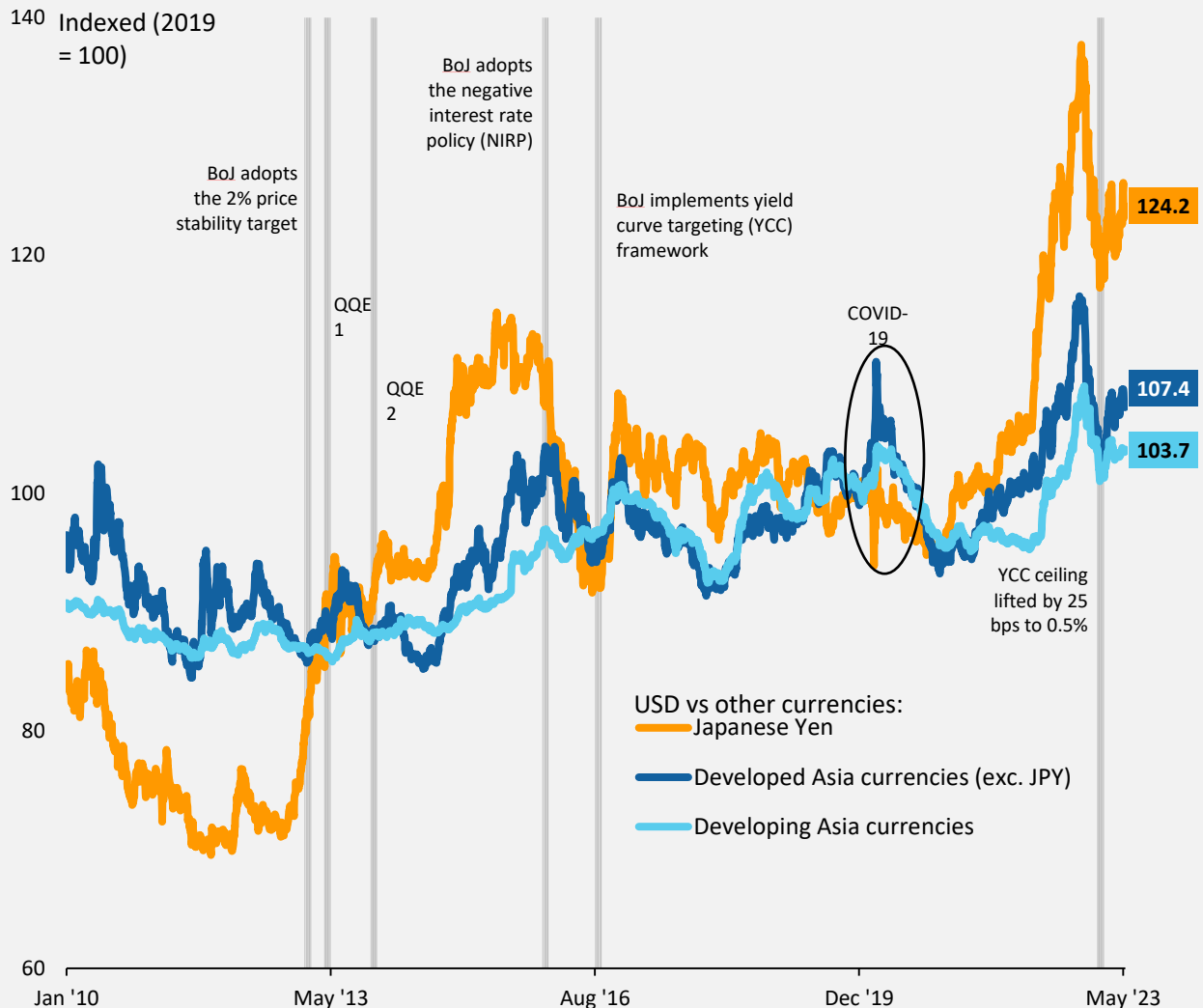


Chart 4

Under one roof

Asian currencies tend to move in tandem with the Japanese Yen, especially following the implementation of BoJ's ultra-easy monetary policy.



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Economic Calendar				
		Actual	Previous	Forecast*
1 May 2023				
US	ISM Manufacturing PMI	47.1	46.3	46.5
2 May 2023				
ID	S&P Global Manufacturing PMI	52.7	51.9	51.6
ID	Inflation Rate YoY	4.33%	4.97%	4.5%
EA	Inflation Rate YoY	7%	6.9%	6.9%
4 May 2023				
US	Fed Interest Rate Decision	5.25%	5%	5.25%
US	Balance of Trade (USD Bn)	-64.2	-70.5	-63.1
7 May 2023				
CN	Foreign Exchange Reserves (USD Bn)	3.205	3.184	3.19
8 May 2023				
ID	Foreign Exchange Reserves (USD Bn)	144.2	145.2	146.0
9 May 2023				
CN	Balance of Trade (USD Bn)	90.21	88.19	76.0
ID	Consumer Confidence	126.1	123.3	123
10 May 2023				
US	Inflation rate YoY	4.9	5%	4.9%
ID	Retail Sales	4.9%	0.6%	1.4%
11 May 2023				
CN	Inflation rate YoY	0.1%	0.7%	0.4%
15 May 2023				
ID	Balance of trade (USD Bn)	3.94	2.83	3.2
16 May 2023				
CN	Industrial Production YoY	-	3.9%	5.8%
EA	Balance of Trade (EUR Bn)	-	4.6	-12.7
18 May 2023				
ID	Motorbike Sales YoY	-	40.5%	-
19 May 2023				
ID	Car Sales YoY	-	2.6%	-
25 May 2023				
ID	Property Price Index YoY	-	2.0%	2.2%
ID	Loan Growth YoY	-	9.93%	1.0%

*Forecasts of some indicators are simply based on market consensus

Bold indicates indicators covered by the BCA Monthly Economic Briefing report

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	12-May	-1 mth	Chg (%)
US	5.25	May-23	0.35	Baltic Dry Index	1,558.0	1,507.0	3.4
UK	4.50	May-23	-5.60	S&P GSCI Index	538.9	592.0	-9.0
EU	3.75	May-23	-3.25	Oil (Brent, \$/bbl)	74.2	85.6	-13.4
Japan	-0.10	Jan-16	-3.30	Coal (\$/MT)	163.0	204.5	-20.3
China (lending)	4.35	May-23	4.25	Gas (\$/MMBtu)	1.98	2.19	-9.6
Korea	3.50	Apr-23	-0.20	Gold (\$/oz.)	2,010.8	2,003.6	0.4
India	6.50	Apr-23	1.80	Copper (\$/MT)	8,222.8	8,851.5	-7.1
Indonesia	5.75	Apr-23	1.42	Nickel (\$/MT)	22,110.0	23,264.0	-5.0
Money Mkt Rates	12-May	-1 mth	Chg (bps)	CPO (\$/MT)	850.9	973.6	-12.6
SPN (1M)	3.49	4.03	-54.4	Rubber (\$/kg)	1.35	1.32	2.3
SUN (10Y)	6.38	6.64	-25.3	External Sector	Apr	Mar	Chg (%)
INDONIA (O/N, Rp)	5.60	5.62	-2.9	Export (\$ bn)	19.29	23.50	-17.90
JIBOR 1M (Rp)	6.40	6.40	0.0	Import (\$ bn)	15.35	20.59	-25.45
Bank Rates (Rp)	Feb	Jan	Chg (bps)	Trade bal. (\$ bn)	3.94	2.91	35.62
Lending (WC)	8.89	8.75	13.80	Central bank reserves (\$ bn)*	144.2	145.2	-0.68
Deposit 1M	4.18	4.00	17.94	Prompt Indicators	Apr	Mar	Dec
Savings	0.67	0.67	0.25	Consumer confidence index (CCI)	126.1	123.3	119.9
Currency/USD	12-May	-1 mth	Chg (%)	Car sales (%YoY)	-28.8	2.7	9.0
UK Pound	0.803	0.805	0.27	Motorcycle sales (%YoY)	-19.4	40.5	24.6
Euro	0.922	0.916	-0.58	Manufacturing PMI	Apr	Mar	Chg (bps)
Japanese Yen	135.7	133.7	-1.49	USA	47.1	46.3	80
Chinese RMB	6.959	6.886	-1.05	Eurozone	45.8	47.3	-150
Indonesia Rupiah	14,750	14,883	0.90	Japan	49.5	49.2	30
Capital Mkt	12-May	-1 mth	Chg (%)	China	49.5	50.0	-50
JCI	6,707.8	6,811.3	-1.52	Korea	48.1	47.6	50
DJIA	33,300.6	33,684.8	-1.14	Indonesia	52.7	51.9	80
FTSE	7,754.6	7,785.7	-0.40				
Nikkei 225	29,388.3	27,923.4	5.25				
Hang Seng	19,627.2	20,485.2	-4.19				
Foreign portfolio ownership (Rp Tn)	Apr	Mar	Chg (Rp Tn)				
Stock	2,789.1	2,726.8	62.33				
Govt. Bond	818.5	818.5	0.00				
Corp. Bond	11.8	12.0	-0.20				

Source: Bloomberg, BI, BPS

Notes:

Car and motorcycle sales data to be released on the third week of January 2022

^Data for January 2022

*Data from an 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

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	5.0
GDP per Capita (US\$)	3927	4175	3912	4350	4784	5011
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	3.4
BI 7-day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	5.75
USD/IDR Exchange Rate (end of the year)**	14,390	13,866	14,050	14,262	15,568	15,173
Trade Balance (US\$ billion)	-8.5	-3.2	21.7	35.3	54.5	28.4
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	1.0	-1.02

*Estimated number

** Estimation of the Rupiah's fundamental exchange rate

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