

## BI Policy:

# Cruise control on a treacherous road

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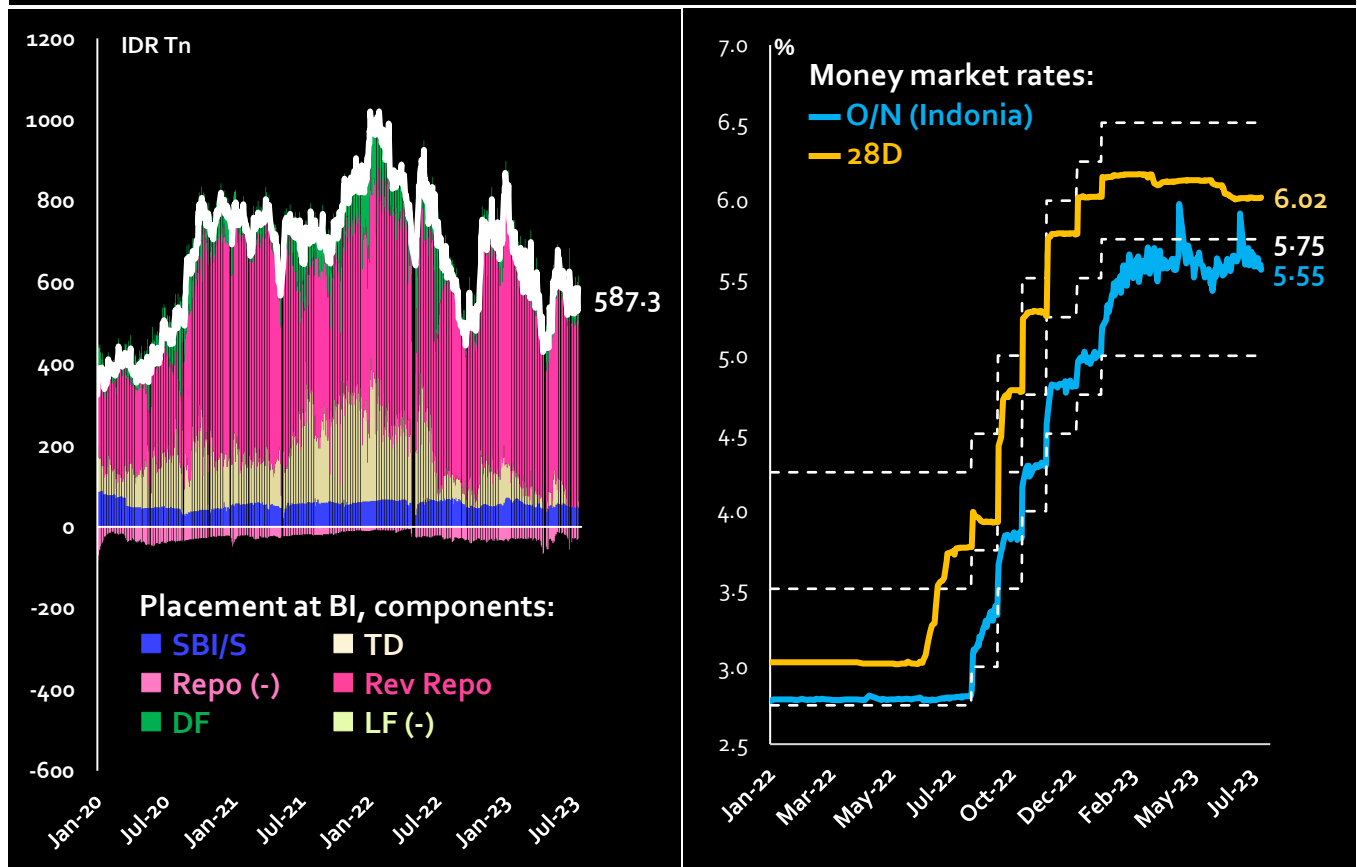
### Executive Summary

- BI kept the BI7DRR at 5.75% for the seventh month in a row, as we await news from the FOMC meeting.
- Widespread expectations of a Fed pivot in H1-24 are putting pressure on the USD, which in theory would allow BI to ease policy, even potentially ahead of the Fed's schedule.
- But the return of food inflation, worsening terms of trade, as well as recent flux in capital flows pattern in relation to interest rate expectations could introduce renewed risks for the Rupiah.
- Our baseline expectation is for the BI7DRR to stay at 5.75% until year-end, while fiscal spending takes center stage in the run up to the Feb-24 General Elections.

- Bank Indonesia maintains the benchmark 7-day Repo Rate (BI7DRR) at 5.75% for the seventh month in a row. This seems to be the natural course of action, as we await the results of the FOMC meeting on July 26th which is widely expected (97%) to bring in another rate hike.
- But if the July hike is largely seen as a done deal, what happens afterwards is much less certain. The Fed's June dot plot leaves one more hike on the table, but the market – especially after the latest 3.0% US CPI print – increasingly believes that the rate hike cycle is ending. There is even a near 50:50 bet that the Fed would start cutting rates by at least Mar-24, as US growth momentum fades.
- As a result, short bets on the USD are becoming a crowded trade (per CFTC data), which – if proven correct – should prop up the IDR. With less exchange rate worries, BI would have more freedom to pursue interest rate cuts, especially now that loan growth has fallen to a 14-month low (at 7.8% YoY) and deposit growth is at its lowest ebb since the start of the pandemic. We mentioned about BI potentially starting to cut earlier than the Fed, which is now a pretty common refrain in the news media.
- But there are several reasons why BI should hold its horses just yet. Firstly, food inflation could be returning not just due to El Nino, but also recent developments (India banning rice exports, Russia withdrawing from the Ukraine grain deal) that threaten to raise grain prices. Not only could this revive inflation in Indonesia (albeit to more limited extent given the government's preparedness), but it could also force the Fed to maintain its hawkish stance for longer, contra recent speculations.

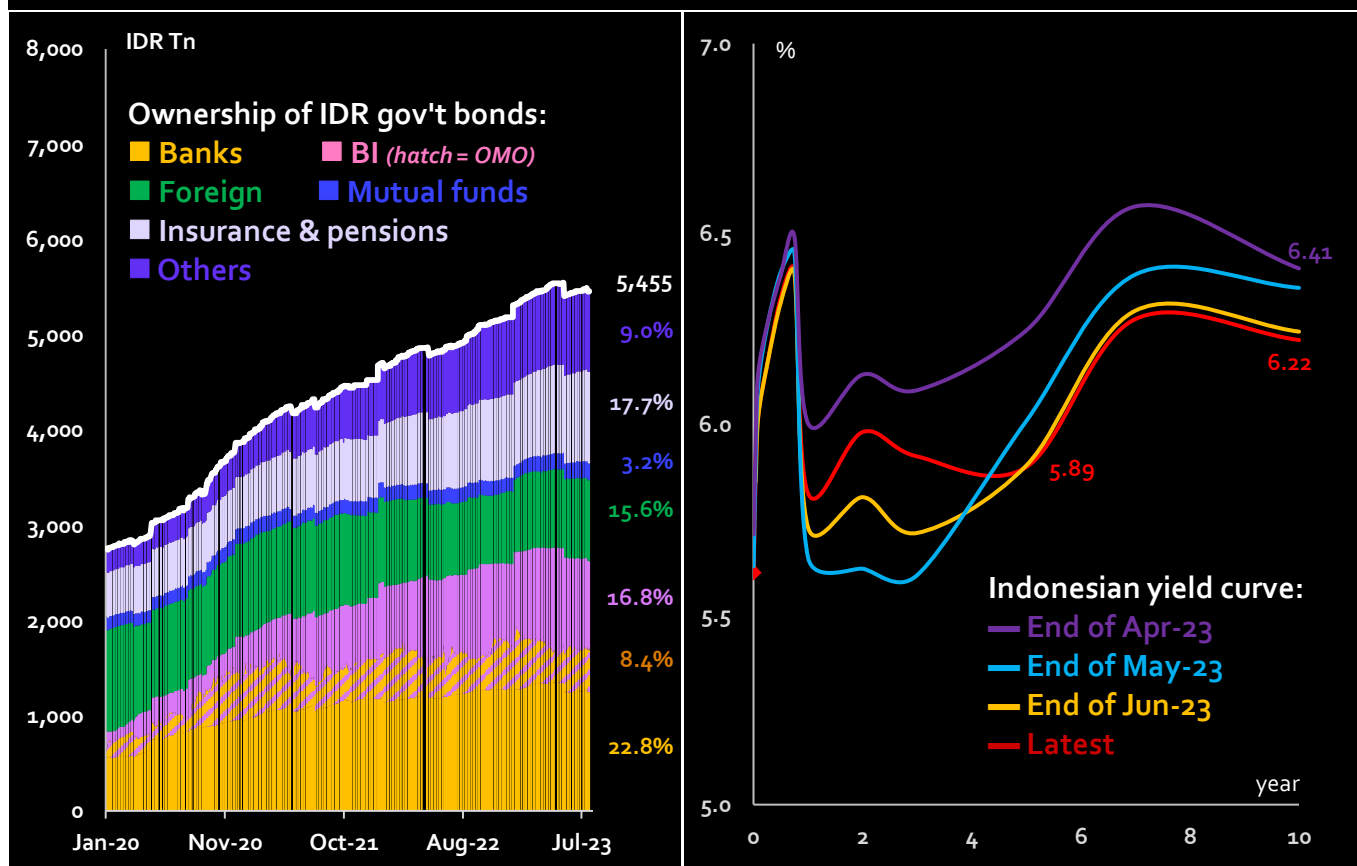
- Secondly, there remains significant vulnerabilities that could threaten the Rupiah in the short-term. BI's FX reserves have narrowed over the last two months, which means less coverage against the risk of short-term outflows. In addition, while the trade surplus proved surprisingly robust in June, the shift in commodities terms of trade are still fundamentally working against Indonesia.
- Remember that Indonesia is a net importer of grains and oil (which could also be rising as Riyadh and Moscow cut output further), while its commodity exports are dominated by coal and metals which depends on China's hitherto-weak demand. Gains from palm oil, which substitutes for Ukraine's sunflower oil, may only partially offset of these losses.
- Thirdly, expectation of earlier rate cut is itself a hazard for the Rupiah. Normally, we would expect IDR/USD to move in tandem with real rate differentials – of which Indonesia still retains a healthy surplus vis-à-vis the US, at least in the longer end of the yield curve.
- But with the exception of the Turkish Lira, the currencies that perform best against the USD recently have been those that show more negative (!) real yield differentials (**see Chart 5**). This is because these (mostly European) currencies are facing higher inflation, and their respective central banks are expected to keep rates high in the future. In contrast, those that have weakened the most like the Chinese Yuan are also those that ease policy ahead of the Fed's schedule.
- Finally, we note that rate cuts may not provide an instant pep to lending, simply because the impact of BI's previous rate hike cycle has yet to be passed on to borrowers. While the BI7DRR rose 225 bps between Aug-22 and Jan-23, loan rates have only risen (Aug-22 to May-23) by an average of 11 bps for consumer loans or around 60 bps for productive loans. Clearly, there are factors beyond just interest rates that hinder loan growth, most notably weaker risk appetite by the business sector.
- All these should be argument enough for BI to stay put until year-end, while waiting to see if the slowdown could be countered by fiscal and pre-election spending in H2-23. BI also retains a few cards up its sleeve, as evidenced by its announcement of larger incentives (i.e. lowered reserves) for banks that lend to SMEs and certain strategic or "green" industries. It remains to be seen if it would also pull out its "ace" i.e. lowering reserve requirement ratio before cutting the BI7DRR, as this could boost liquidity without unduly affecting market sentiment on the IDR.

**Panel 1. BI continues staying put as excess liquidity remains available in the system**



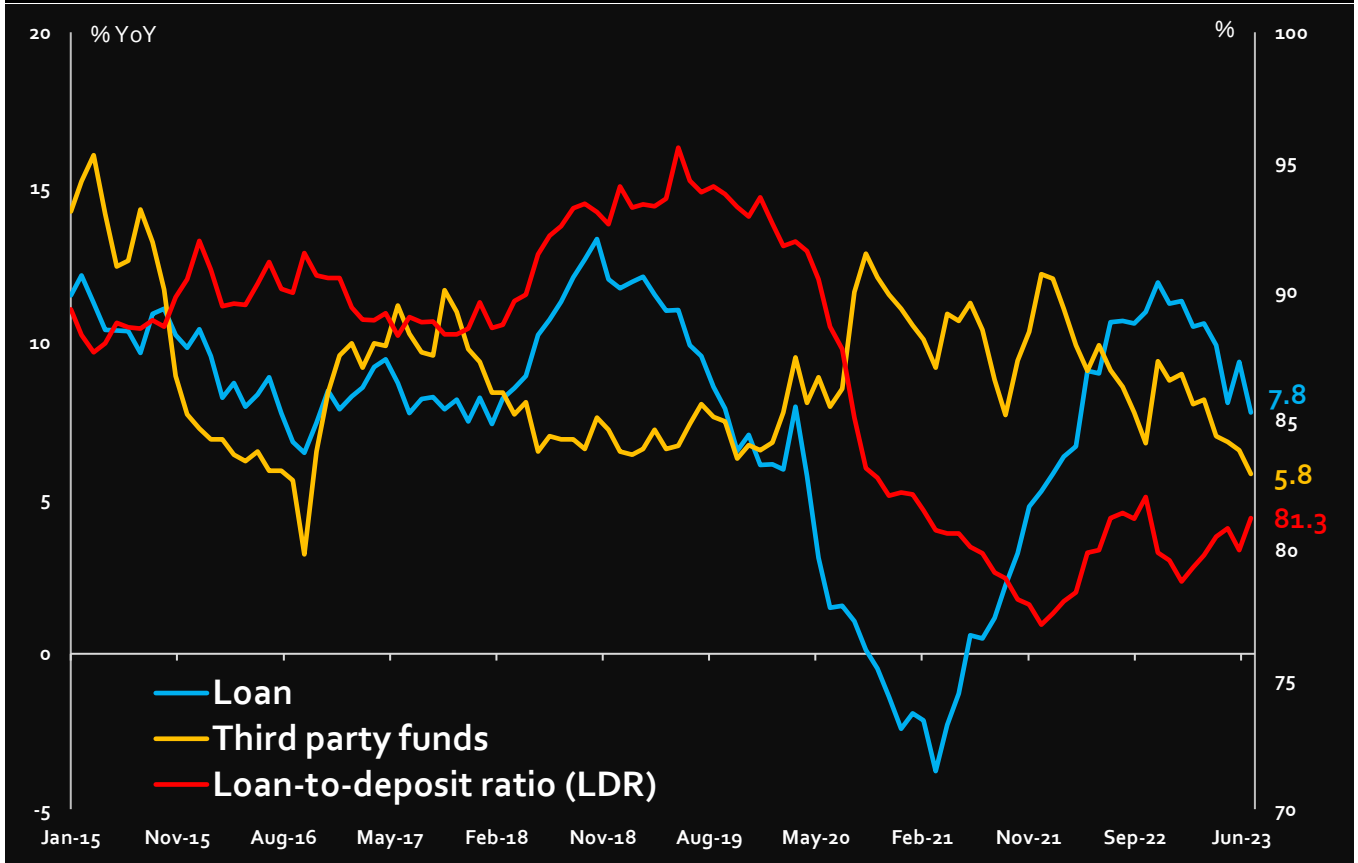
Source: BI, Bloomberg, BCA Economist

**Panel 2. Yield curve has been flattening as net gov't bond issuance slows more recently**



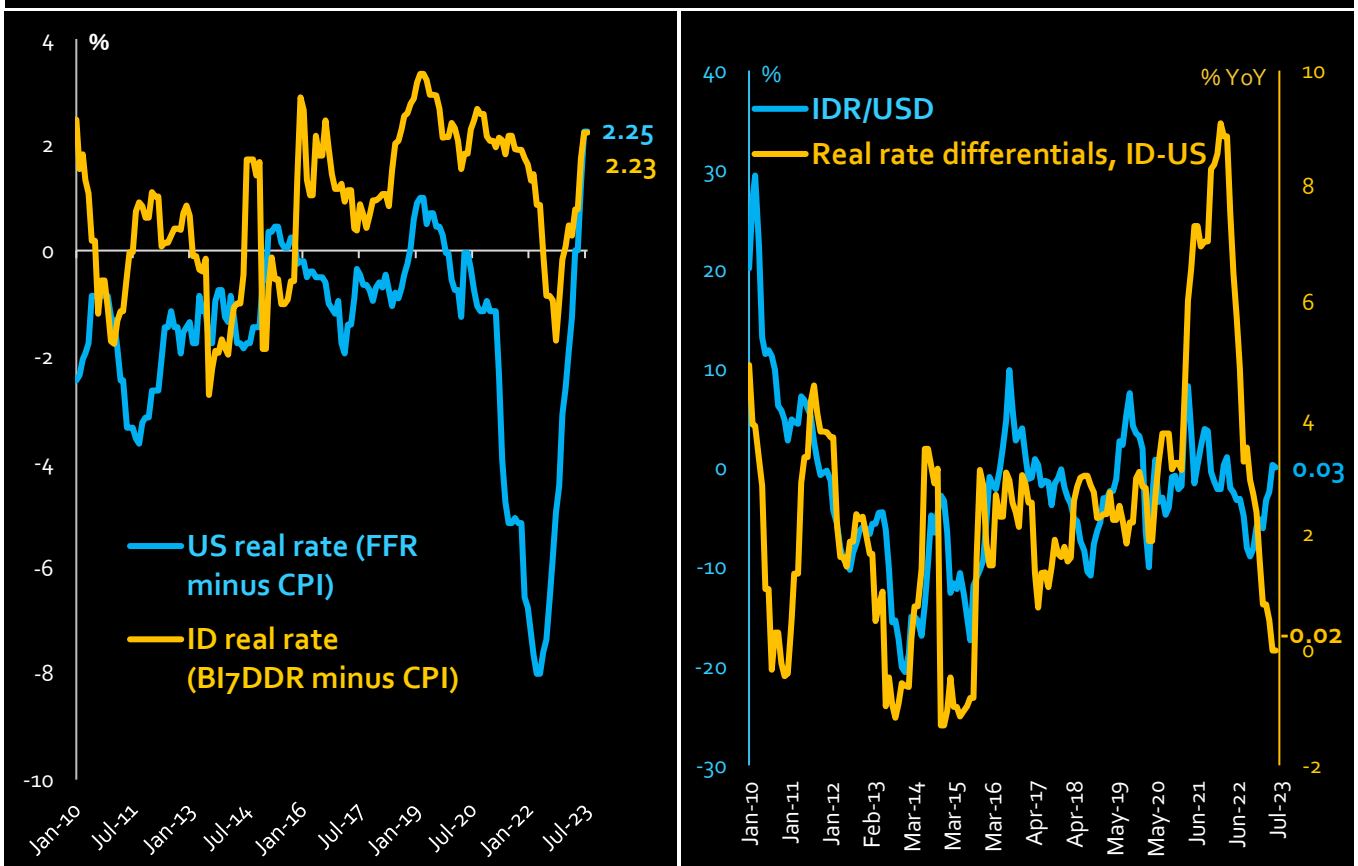
Source: MoF, BI, Bloomberg, BCA Economist

**Panel 3. Loan growth have been moderating, but deposits have slowed even further**



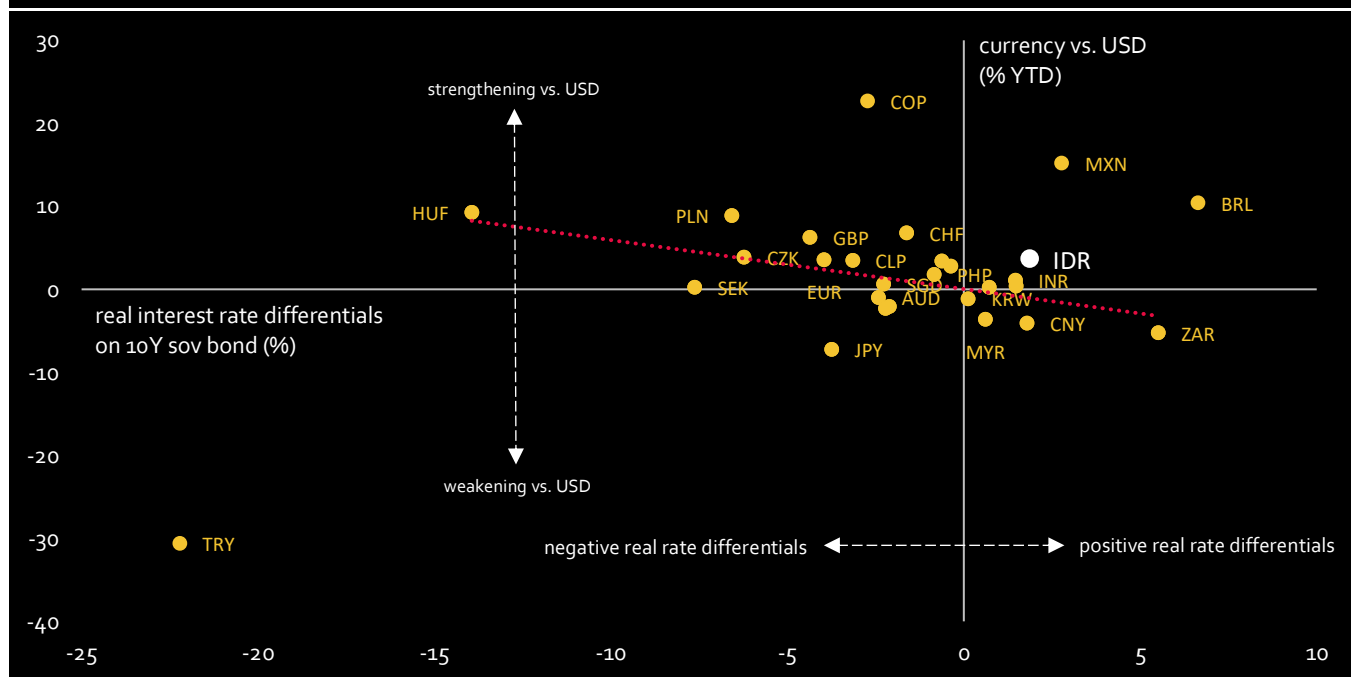
Source: OJK, BI, BCA Economist

**Panel 4. Rupiah exchange rate has somewhat decoupled from rate differentials in recent years**



Source: BI, Bloomberg, BCA Economist

**Chart 5. Except for Turkey, countries with more negative yield differentials have actually performed better versus the USD this year**



Source: Bloomberg, BCA Economist

## Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	24-Jul	-1 mth	Chg (%)
US	5.25	Jul-23	2.25	Baltic Dry Index	967.0	1,240.0	-22.0
UK	5.00	Jul-23	-2.90	S&P GSCI Index	586.0	541.6	8.2
EU	4.00	Jul-23	-1.50	Oil (Brent, \$/bbl)	82.7	73.9	12.0
Japan	-0.10	Jan-16	-3.40	Coal (\$/MT)	148.2	142.7	3.9
China (lending)	4.35	Jul-23	4.35	Gas (\$/MMBtu)	2.67	2.22	20.3
Korea	3.50	Jul-23	0.80	Gold (\$/oz.)	1,954.7	1,921.2	1.7
India	6.50	Jun-23	1.69	Copper (\$/MT)	8,487.8	8,409.2	0.9
Indonesia	5.75	Jul-23	2.23	Nickel (\$/MT)	21,199.0	21,117.0	0.4
Money Mkt Rates	24-Jul	-1 mth	Chg (bps)	CPO (\$/MT)	874.3	779.7	12.1
SPN (1M)	4.88	4.80	8.2	Rubber (\$/kg)	1.27	1.31	-3.1
SUN (10Y)	6.22	6.28	-5.8	External Sector	Jun	May	Chg (%)
INDONIA (O/N, Rp)	5.61	5.61	0.4	Export (\$ bn)	20.61	21.71	-5.08
JIBOR 1M (Rp)	6.40	6.39	1.3	Import (\$ bn)	17.15	21.28	-19.40
Bank Rates (Rp)	Apr	Mar	Chg (bps)	Trade bal. (\$ bn)	3.45	0.43	708.66
Lending (WC)	8.92	8.95	-2.71	Central bank reserves (\$ bn)*	137.5	139.3	-1.28
Deposit 1M	4.18	4.20	-2.70	Prompt Indicators	Jun	May	Apr
Savings	0.67	0.69	-1.70	Consumer confidence index (CCI)	127.1	128.3	126.1
Currency/USD	24-Jul	-1 mth	Chg (%)	Car sales (%YoY)	4.7	65.2	-28.8
UK Pound	0.779	0.787	0.90	Motorcycle sales (%YoY)	66.6	113.4	-19.4
Euro	0.904	0.918	1.56	Manufacturing PMI	Jun	May	Chg (bps)
Japanese Yen	141.5	143.7	1.57	USA	46.0	46.9	-90
Chinese RMB	7.187	7.179	-0.11	Eurozone	43.4	44.8	-140
Indonesia Rupiah	15,023	14,994	-0.19	Japan	49.8	50.6	-80
Capital Mkt	24-Jul	-1 mth	Chg (%)	China	50.5	50.9	-40
JCI	6,899.4	6,639.7	3.91	Korea	47.8	48.4	-60
DJIA	35,411.2	33,727.4	4.99	Indonesia	52.5	50.3	220
FTSE	7,678.6	7,461.9	2.90				
Nikkei 225	32,700.9	32,781.5	-0.25				
Hang Seng	18,668.2	18,890.0	-1.17				
Foreign portfolio ownership (Rp Tn)	Jun	May	Chg (Rp Tn)				
Stock	2,755.0	2,738.1	16.95				
Govt. Bond	846.9	829.4	17.53				
Corp. Bond	11.3	11.8	-0.47				

Source: Bloomberg, BI, BPS

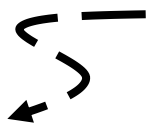
Notes:

^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



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## 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	5285
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	2.3
BI 7 day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	5.75
USD/IDR Exchange Rate (end of 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	35.3
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	1.0	-0.7

\*Estimated number

\*\* Estimation of Rupiah's fundamental exchange rate

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