Waiting calmly for the long and variable lag

28 August 2023

Lazuardin Thariq Hamzah
lazuardin_hamzah@bca.co.id

Barra Kukuh Mamia
barra_mamia@bca.co.id

Summary

- The "higher-for-longer" expectation for the US policy rate have strengthened following the Jackson Hole conference, fuelling the rally in the USD's value while also sending the yield on UST securities higher.
- Despite the likely prolonged period of high-interest rate, the terminal FFR rate may not be necessarily higher given the lengthened duration of lags in monetary policy transmission amidst the still-ample liquidity condition in the US economy.
- The observed lengthening transmission lag is also evident in Indonesia. This situation, combined with BI's increasing policy independence following the introduction of new instruments, may allow BI to keep its policy posture despite the risk of rate parity with the Fed.

- The Federal Reserve and other central banks' officials have returned home after the Jackson Hole economic symposium held last week, during which they engaged in a three-day discussion about their perspectives on interest rates and the economy. During his session, Fed chairman Jerome Powell borrowed some words from his predecessor Paul Volcker, cautioning that inflation remains too high and pledging that the Fed would "keep at it" to bring inflation back to the sacrosanct 2% target.
- Chairman Powell's assertion that inflation remains too high for the Fed's liking is not short-sighted. The core PCE inflation, which is the Fed's preferred inflation gauge, stood at 4.09% YoY in June 2023, exhibiting minimal change from the 4.68% YoY observed early in the year. The 3.17% YoY retail sales growth in July 2023 (1.59% YoY in the previous month) also shows that consumer demand in the US continues to heat up as we move deeper into 2023. These hitherto strong headline numbers lead to the expectation that the US economy is still in good shape to stomach more restrictive monetary policies, leading to the continued increase in the yield of US treasury securities and the prolonged rally in the USD's value.
- Concerns over a potential supply shock in the commodity market, the shifting neutral interest rate level (R*), and even the historical parallel between the present inflationary period with that of 1970-1980 inflation add more voices to the calls for the Fed to make good on its "higher-for-longer" outlook ***(see Chart 1)***. However, while the policy rate is likely to be substantially restrictive for a prolonged period, excerpts

from the conference show that the terminal FFR rate might not be necessarily higher.

- The deteriorating prospects of the US public debt appear to take centre stage in discussions about why the Fed may hesitate to raise the policy rate beyond the projected 5.50-5.75% range. We should note, however, that while the subsequent re-pricing in the UST market is a noteworthy development, such a development falls outside the Fed's dual mandate – suggesting that there should be another factor other than the credibility-threatening fiscal dominance that hitherto influenced FOMC officials' "high-for-longer" signals.

- The rationale behind the new HFL (high-for-longer) outlook stems from the characteristic of monetary policy itself. Monetary policies, of course, work through a long and variable lag. Given the enduring strength of aggregate demand growth in the US and thus the supply improvement-driven disinflation, the duration of monetary transmission lags during the ongoing inflationary period may turn out to be longer. Tailwinds from the pandemic days, most notably the high level of excess liquidity within households and the corporate sector. Ample liquidity allowed businesses and consumers to continue consuming without significantly increasing their leverage – lessening the potency of the Fed's effort to curb the supply and thus prices of loans through its aggressive rate-tightening campaign throughout H1 2022-H1 2023.

"The Fed is likely to keep the rate environment substantially restrictive for a prolonged period, but the terminal rate may not necessarily be higher"

- The Fed's effort to increase the supply of loans may start to take more bite in H2 2023 compared to the previous period. The dwindling excess savings, coupled with increasing residential and non-residential investments, may force consumers and businesses to start looking for more leverage again, exposing them to the present reality of lower supply and higher prices of loans. Thus, the Fed might opt to wait for the current policy posture to penetrate more profoundly into the real economy, rather than further increasing the price of loans and potentially risking an over-tightening that may force the central bank to take an equally aggressive loosening response should the economy enters a recession.

- A somewhat analogous scenario, where shifts in monetary policies appear to experience a prolonged lag in affecting the real economy, also seems to have unfolded in Indonesia. The domestic economy did enjoy a disinflationary spell in 2022-2023; however, determining the extent to which this disinflationary trend is attributable to BI's policy rate tightening rather than improvements in the global supply situation is a subject of debate. BI's tightening campaign from August 2022-January 2023 also seems to have had a muted effect on interest rates of bank loans thus far ***(see Chart 2)***, adding to the argument that BI's 225 bps rate hike is yet to fully resonate throughout the domestic economy in H1 2023.

- The lengthened lag in the transmission of BI's monetary policy to the real economy could be attributed to similar factors as in the US: the ample liquidity within the domestic economy. Indeed, our analysis of the domestic corporate sector shows that businesses continue to cut their exposure to debt in Q2 2023, rendering the increase in prices of loans somewhat irrelevant as businesses – especially in the commodity-producing sector - continue to fund their operation and investments through retained earnings.
- Indonesian businesses and households, however, may walk into the new quarter with less cash in hand ***(see Chart 3)***. The reversal in Indonesia's balance of payment position in Q2 2023 confirmed the dwindling liquidity condition in the domestic economy, which given the still-robust outlook for investments and consumption, may finally expose businesses and households to the present reality of higher prices of loans. Thus, similar to the Fed, It might be more suitable for BI to wait for the 225bps rate hike to fully transmit to the economy rather than further increasing the price of loans. The Fed's HFL outlook may weaken foreign demand for Indonesian assets, as evidenced by the USD 360 Mn in capital outflows from the bond market recorded last week. But this reading leads us to reject the increasingly vociferous calls for BI to increase the interest rate again amidst the risk of BI7DRR-FFR rate parity, given that the lagging monetary policy may not be the most suitable tool to combat the short-term volatility in the domestic market.
- Moreover, the SRBI instrument to be launched in mid-September 2023 would provide another tool for BI to stabilise the domestic bond market. Indeed, the new instrument would allow BI to deploy the SBN they accumulated during the pandemic to absorb liquidity, not just from banks but – since SRBI is tradable in the secondary market – also from retail and foreign investors ***(see Table 1)***. Also, by allowing SRBI to be traded in the secondary market, BI may help to improve the liquidity for more productive SBN, securing the financing needs that may stem from the government's many projects.
- Lastly, depending on its success, the SRBI tool may also allow BI to shepherd investors into the less-liquid part of the domestic bond market, as the central bank could re-package illiquid assets into more-liquid SRBI. The central bank, then, is not short of tools to stabilise the domestic market from volatilities in the global economy, as the new SRBI instrument and the government's strengthened DHE rule would increase BI's policy independence from the Fed.

"Ample liquidity in the private sector limits the potency of BI's policy tightening, but the situation may soon change given the worsening liquidity conditions starting in Q2 2023"

Chart 1

Longer but no higher

Market participants pushed the rate cut expectation to Q2 2023 but remain sceptical that the Fed would continue increasing the interest rate.

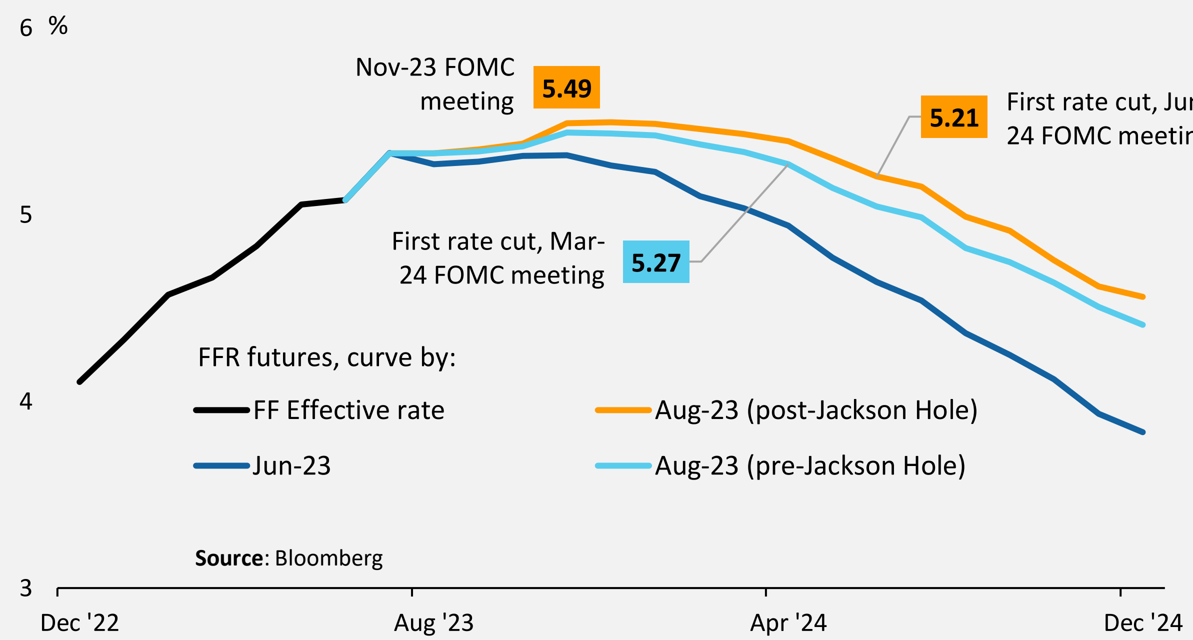


Chart 2

Lagging transmissions

BI's tightening campaign in 2022-2023 hitherto had a muted impact on rates offered by banks due to the still-ample liquidity in the domestic private sector.

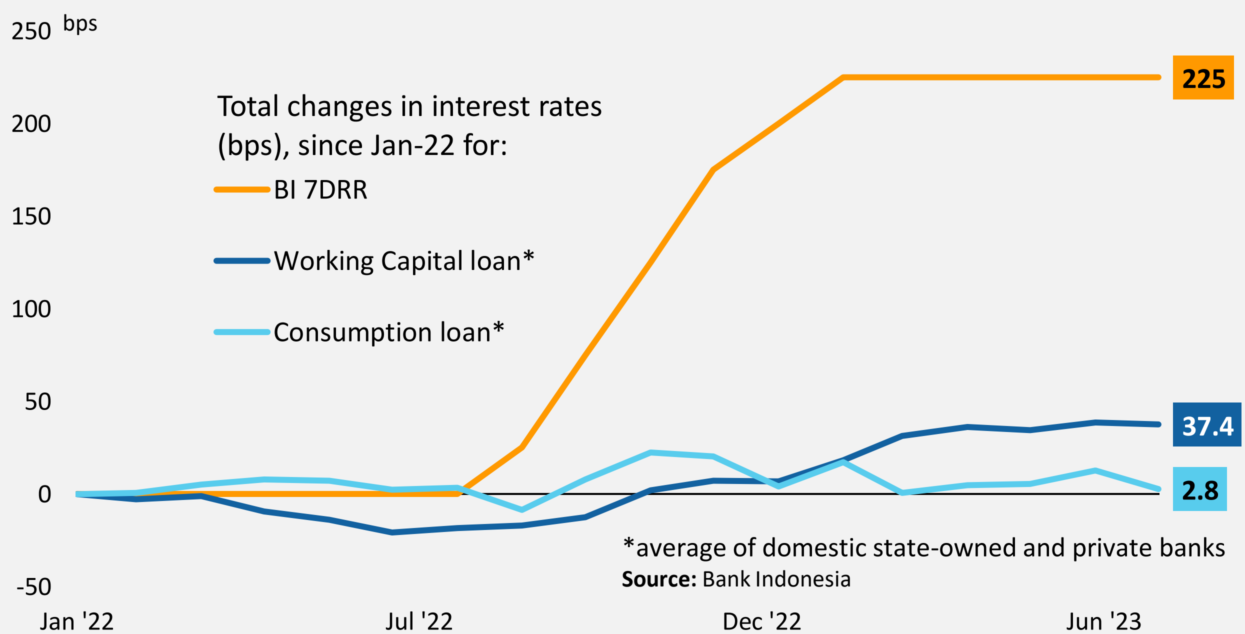
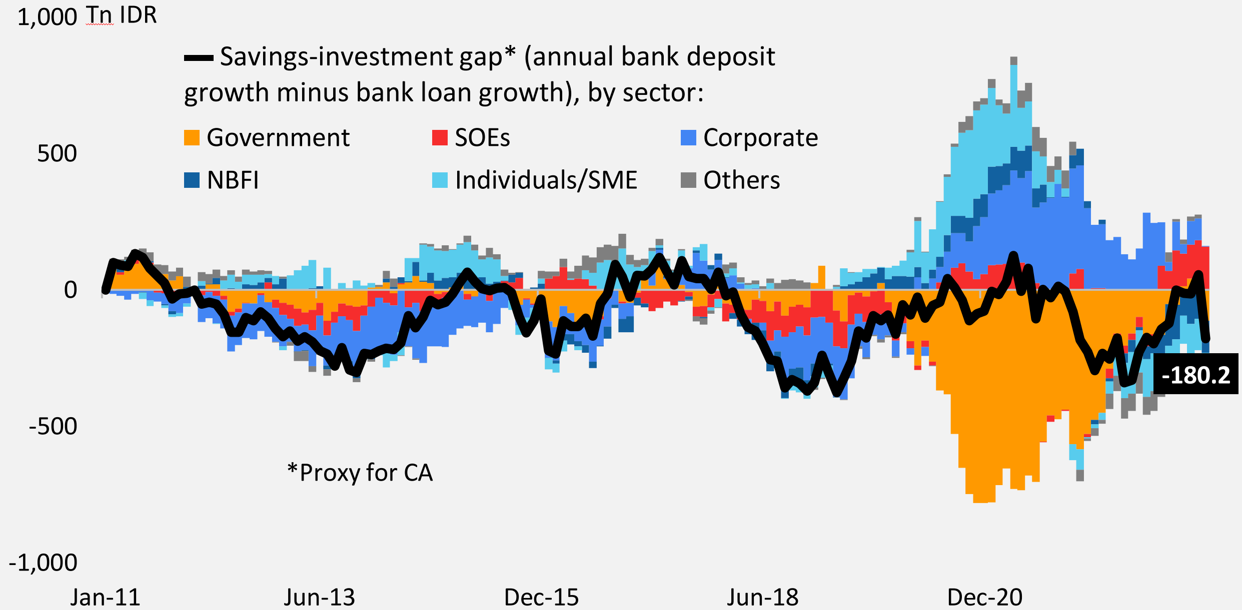


Chart 3

The lag may soon pass

The dwindling liquidity condition in Q2 2023 and subsequent periods mean that BI's policy tightening in Aug 2022 – Jan 2023 may soon fully transmit to the real economy



Source: Bloomberg, DJPPR, calculations by BCA Economic Research

Table 1

New instruments in hands

BI's new SRBI instrument is more of a tool to allow the government to tap into foreign and retail funds rather than an exit strategy from the pandemic-era bond-buying programme.

Features and characteristics	SRBI	RR SBN	SBI	SukBI
Open market Instrument	Conventional	Conventional	Conventional	Sharia
Characteristic	New security issuance	Repo-based issuance	New security issuance	New security issuance
Underlying assets	BI SBN	BI SBN	-	SBSN and BI global Sukuk
Term	One week to 12 months	One day to 12 months	One month to 12 months	One day to 12 months
Yield	Discount	Simple Interest	Discount	Paid when due
Minimum transaction amount	IDR 1 Billion			
Multiples of the bid amount	IDR 100 million			
Transferable	Yes (Bank and non-Bank may own it)	No	Yes (Bank and non-Bank may own it)	Yes (be owned only by banks)

Source: Bank Indonesia

Economic Calendar

		Actual	Previous	Forecast*
1 August 2023				
ID	S&P Manufacturing PMI	53.3	52.5	52
ID	**Inflation Rate YoY**	**3.08%**	**3.52%**	**3.2%**
CN	Caixin Manufacturing PMI	49.2	50.5	50.3
US	S&P Manufacturing PMI	49	46.3	49
US	JOLTs Job Opening	9.582	9.616	9.6
3 August 2023				
UK	BoE Bank Rate Decision	5.25%	5.00%	5.00%
4 August 2023				
US	Unemployment Rate	3.5%	3.6%	3.6%
US	Non-Farm Payroll ('000)	187	185	200
7 August 2023				
ID	**Foreign Exchange Reserves (USD (Bn)**	**137.7**	**137.5**	**140.0**
ID	**GDP Growth Rate YoY**	**5.17%**	**5.03%**	**5.1%**
CN	Foreign Exchange Reserves (USD Tn)	3.20	3.19	3.19
8 August 2023				
ID	Consumer Confidence	123.5	127.1	127.5
CN	Balance of Trade (USD Bn)	80.6	70.6	69
US	Balance of Trade (USD Bn)	-65.5	-69	-65.1
9 August 2023				
CN	Inflation rate YoY	-0.3%	0%	-0.3%
ID	Motorbike Sales YoY	45.6%	66.6%	-
ID	Retail Sales YoY	7.9%	-4.5%	3.1
10 August 2023				
US	Inflation rate YoY	3.2%	3%	3.1%
ID	Car Sales YoY	-6.7%	4.6%	-
15 August 2023				
ID	**Balance of Trade (USD Bn)**	**1.31**	**3.46**	**2.7**
US	Retail Sales YoY	3.2%	1.6%	1.0%
22 August 2023				
ID	**Current Account (USD Bn)**	**-1.9**	**3.0**	**-1.6**
24 August 2023				
ID	**Interest Rate Decision**	**5.75%**	**5.75%**	**5.75%**
28 August 2023				
ID	Money supply growth (M2, YoY)	6.4%	6.1%	-

*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 (%)
US	5.50	Aug-23	2.30
UK	5.25	Aug-23	-1.55
EU	4.25	Aug-23	-1.05
Japan	-0.10	Jan-16	-3.40
China (lending)	2.50	Aug-23	4.65
Korea	3.50	Aug-23	1.20
India	6.50	Aug-23	-0.94
Indonesia	5.75	Aug-23	2.67
Money Mkt Rates	**25-Aug**	**-1 mth**	**Chg (bps)**
SPN (1M)	5.43	5.38	5.2
SUN (10Y)	6.50	6.22	28.4
INDONIA (O/N, Rp)	5.60	5.52	8.6
JIBOR 1M (Rp)	6.40	6.40	0.0
Bank Rates (Rp)	**May**	**Apr**	**Chg (bps)**
Lending (WC)	8.93	8.92	0.35
Deposit 1M	4.19	4.18	1.37
Savings	0.67	0.67	0.00
Currency/USD	**25-Aug**	**-1 mth**	**Chg (%)**
UK Pound	0.795	0.775	-2.51
Euro	0.926	0.905	-2.34
Japanese Yen	146.4	140.9	-3.78
Chinese RMB	7.287	7.136	-2.07
Indonesia Rupiah	15,295	14,993	-1.97
Capital Mkt	**25-Aug**	**-1 mth**	**Chg (%)**
JCI	6,895.4	6,917.7	-0.32
DJIA	34,346.9	35,438.1	-3.08
FTSE	7,338.6	7,691.8	-4.59
Nikkei 225	31,624.3	32,682.5	-3.24
Hang Seng	17,956.4	19,434.4	-7.61
Foreign portfolio ownership (Rp Tn)	**Jul**	**Jun**	**Chg (Rp Tn)**
Stock	2,892.9	2,755.0	137.88
Govt. Bond	846.9	846.9	0.00
Corp. Bond	11.3	11.3	-0.03

Trade & Commodities	25-Aug	-1 mth	Chg (%)
Baltic Dry Index	1,080.0	962.0	12.3
S&P GSCI Index	585.0	588.9	-0.7
Oil (Brent, $/brl)	84.5	83.6	1.0
Coal ($/MT)	160.6	154.6	3.9
Gas ($/MMBtu)	2.46	2.66	-7.5
Gold ($/oz.)	1,915.0	1,965.0	-2.5
Copper ($/MT)	8,319.3	8,641.3	-3.7
Nickel ($/MT)	20,616.0	22,201.0	-7.1
CPO ($/MT)	820.2	889.9	-7.8
Rubber ($/kg)	1.31	1.29	1.6
External Sector	**Jul**	**Jun**	**Chg (%)**
Export ($ bn)	20.88	20.60	1.36
Import ($ bn)	19.57	17.15	14.10
Trade bal. ($ bn)	1.31	3.45	-61.96
Central bank reserves ($ bn)*	137.7	137.5	0.12
Prompt Indicators	**Jul**	**Jun**	**May**
Consumer confidence index (CCI)	123.5	127.1	128.3
Car sales (%YoY)	-6.8	4.7	65.2
Motorcycle sales (%YoY)	45.6	66.6	113.4
Manufacturing PMI	**Jul**	**Jun**	**Chg (bps)**
USA	46.4	46.0	40
Eurozone	42.7	43.4	-70
Japan	49.6	49.8	-20
China	49.2	50.5	-130
Korea	49.4	47.8	160
Indonesia	53.3	52.5	80

Source: Bloomberg, BI, BPS

Notes:

^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

Scan for the link to our report depository or **click**:

https://s.id/BCA_REI

Indonesia – Economic Indicators Projection

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	5.2
GDP per Capita (US$)	3927	4175	3912	4350	4784	5285
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	2.7
BI 7-day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	5.75
USD/IDR Exchange Rate (end of the year)**	14,390	13,866	14,050	14,262	15,568	15,173
Trade Balance (US$ billion)	-8.5	-3.2	21.7	35.3	54.5	35.3
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	1.0	-0.7

*Estimated number

** Estimation of the 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

Agus Salim Hardjodinoto
Head of Industry and Regional Research
agus_lim@bca.co.id
+6221 2358 8000 Ext: 1005314

Barra Kukuh Mamia
Senior Economist
barra_mamia@bca.co.id
+6221 2358 8000 Ext: 1053819

Victor George Petrus Matindas
Senior Economist
victor_matindas@bca.co.id
+6221 2358 8000 Ext: 1058408

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

Keely Julia Hasim
Economist / Analyst
keely_hasim@bca.co.id
+6221 2358 8000 Ext: 1071535

Elbert Timothy Lasiman
Economist / Analyst
Elbert_lasiman@bca.co.id
+6221 2358 8000 Ext: 1074310

Thierris Nora Kusuma
Economist / Analyst
thierris_kusuma@bca.co.id
+6221 2358 8000 Ext: 1071930

Firman Yosep Tember
Research Assistant
firman_tember@bca.co.id
+6221 2358 8000 Ext: 20378

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