FX Reserves: As good as it gets?

Executive Summary:

- **FX reserves rose to USD 137.3 Bn in July, but it increased less than expected from global bond issuance, given strong capital account pressures during the month.**
- **So far, USD/IDR has not deviated too much from its fundamental drivers, but real interest rate differentials are at very high levels – implying substantial headwinds against portfolio inflows in the medium-term.**
- **Going forward, support for USD/IDR will probably come more from the current account improvement relative to pre-pandemic levels, both of the "good" kind (more exports) and the "bad" kind (less imports).**

- BI's international reserves position showed slight improvement, from USD 137.1 Bn in June to USD 137.3 Bn in July. On the surface, this seems in line with the Rupiah's modest appreciation during the month. It also fits with the risk-off, but quite calm sentiment in the global market amid the ongoing third wave of Covid-19.

- Dig beneath the surface, however, and we might see some concerning signs with respect to Indonesia's capital account. For one, the increase in reserves was much smaller than the amount expected given the government's global bond issuance during the month, which totaled USD 1.65 Bn plus Euro bonds worth EUR 0.5 Bn.

- This discrepancy is explicable if we look at domestic USD liquidity indicators. On the banking side, we saw the total amount outstanding of BI USD instruments held by banks falling by USD 1.2 Bn (***Chart 1***). Its relative stagnation throughout 2021 contrasts with what happened last year, when global bond issuance had clear positive impact on domestic USD liquidity (most notably, the USD 4.3 Bn tranche issued in April 2020).

- Foreign portfolio investors also recorded net outflows of about USD 0.5 Bn in July, after posting their strongest monthly inflows since the pandemic began in June (***Chart 2***). This is not at all a surprise given the worsening risk perception of Indonesia as one the worst-hit countries during this third wave.

- All **in all, these suggest that the replenishment from global bonds were quickly used up either via outflows, FX interventions, or other usage by the domestic economy.** This does not mean that FX liquidity in the future will drain out as quickly as it did in July – which was, in all likelihood, quite an exceptional month. But it does provide a glimpse of the challenge ahead.

- Historically, the trajectory of USD/IDR has been largely influenced by the capital account side of the balance of payments (BoP). In our estimates, about 60% of USD/IDR movement could be explained by just the movement of the Dollar index and the real interest rate differentials between IDR and USD assets (we use a mix of overnight and longer-dated instruments).

- As it stands, IDR has not deviated that much from these fundamental drivers (***Chart 3***). **But it is worth bearing in mind how favorable the situation currently is, especially with regards to real rate differentials** (***Chart 4***). The odds that such a wide gap could be maintained to 2022 is probably quite decent, but beyond that it will likely narrow, as the Fed tightens policy and inflation reverts to their respective long-run levels (i.e. higher in Indonesia and lower in the US).

- **Given limited upside on the capital account side (aside from FDI), the burden of maintaining Rupiah stability will fall more and more onto the current account side.** As we see in ***Chart 3***, some of the deviation between Rupiah and its capital account drivers could be accounted for by favorable trade balance, as was the case in the 2006-2008 period.

- The question, then, is whether or not the current account improvement will be of the "good" kind (more exports) or the "bad" kind (less finished goods imports). The former is a good bet given high commodity prices, but the latter is also probable as fiscal and monetary policies tighten concurrently, perhaps from the end of 2022 onwards.

- **If both holds true, the post-pandemic recovery could resemble the protracted recovery between 2000-08.** The collapse in banks' loan-to-deposit ratio (and the corresponding rise in current account balance) took years to be reversed, but it did allow for several years of rapid, commodity-fueled growth in between.

Chart 1. FX reserves has been relatively flat during 2021, despite periodic global bond issuance e.g. in July

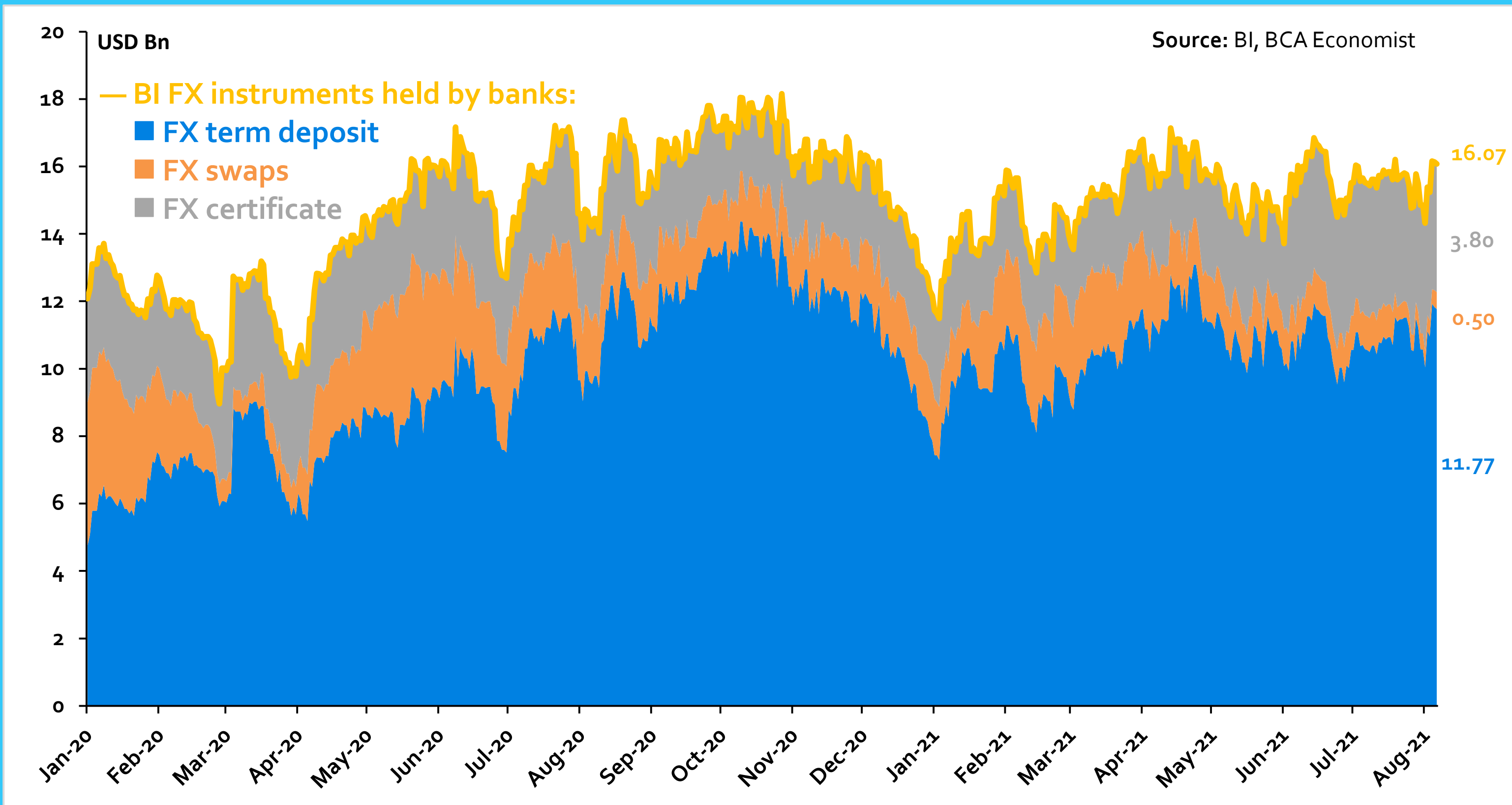


Chart 2. Foreign capital went back to outflow mode in July as Covid cases in Indonesia surged

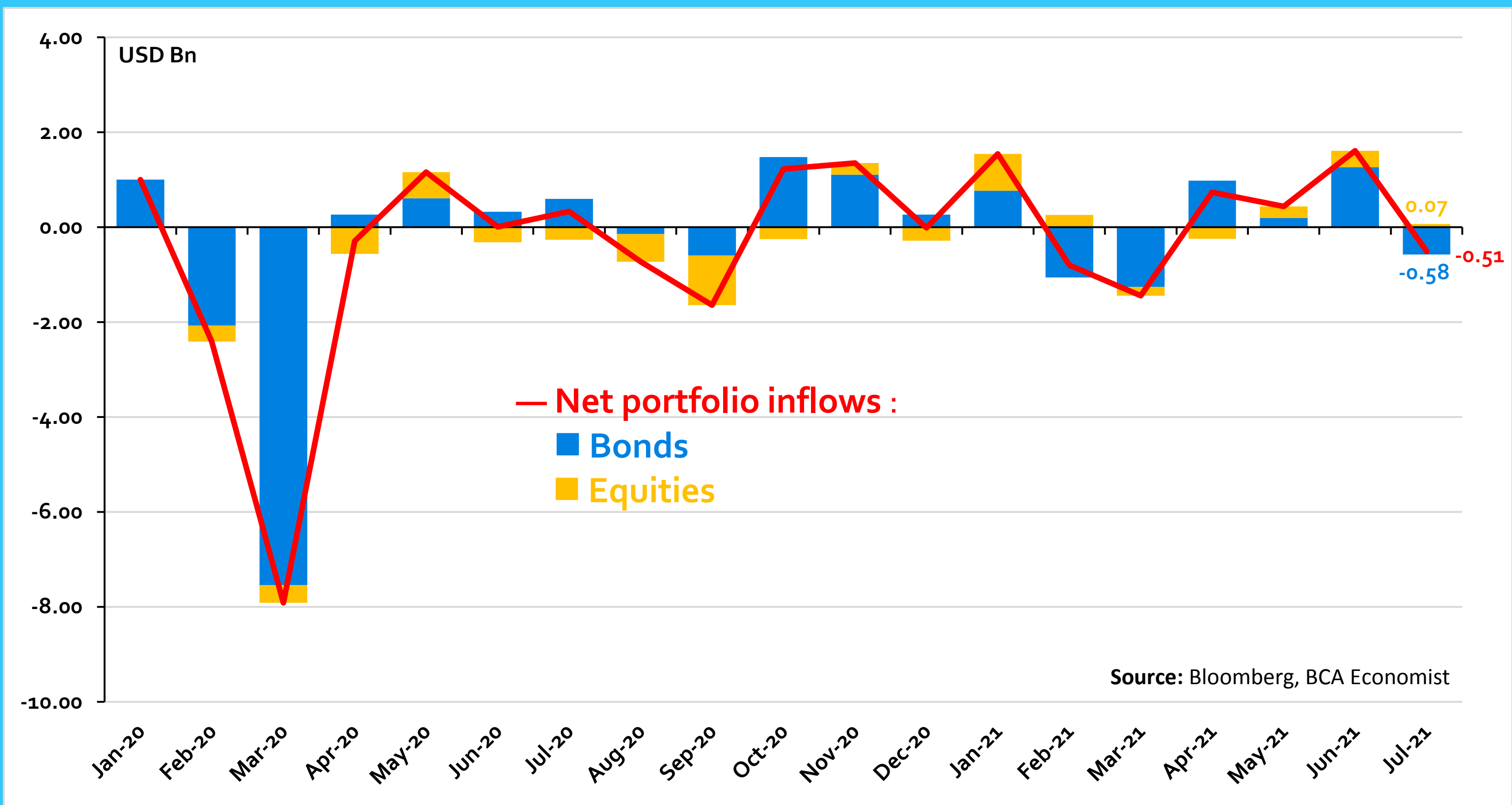


Chart 3. USD/IDR movement has historically been determined mainly by capital account drivers …

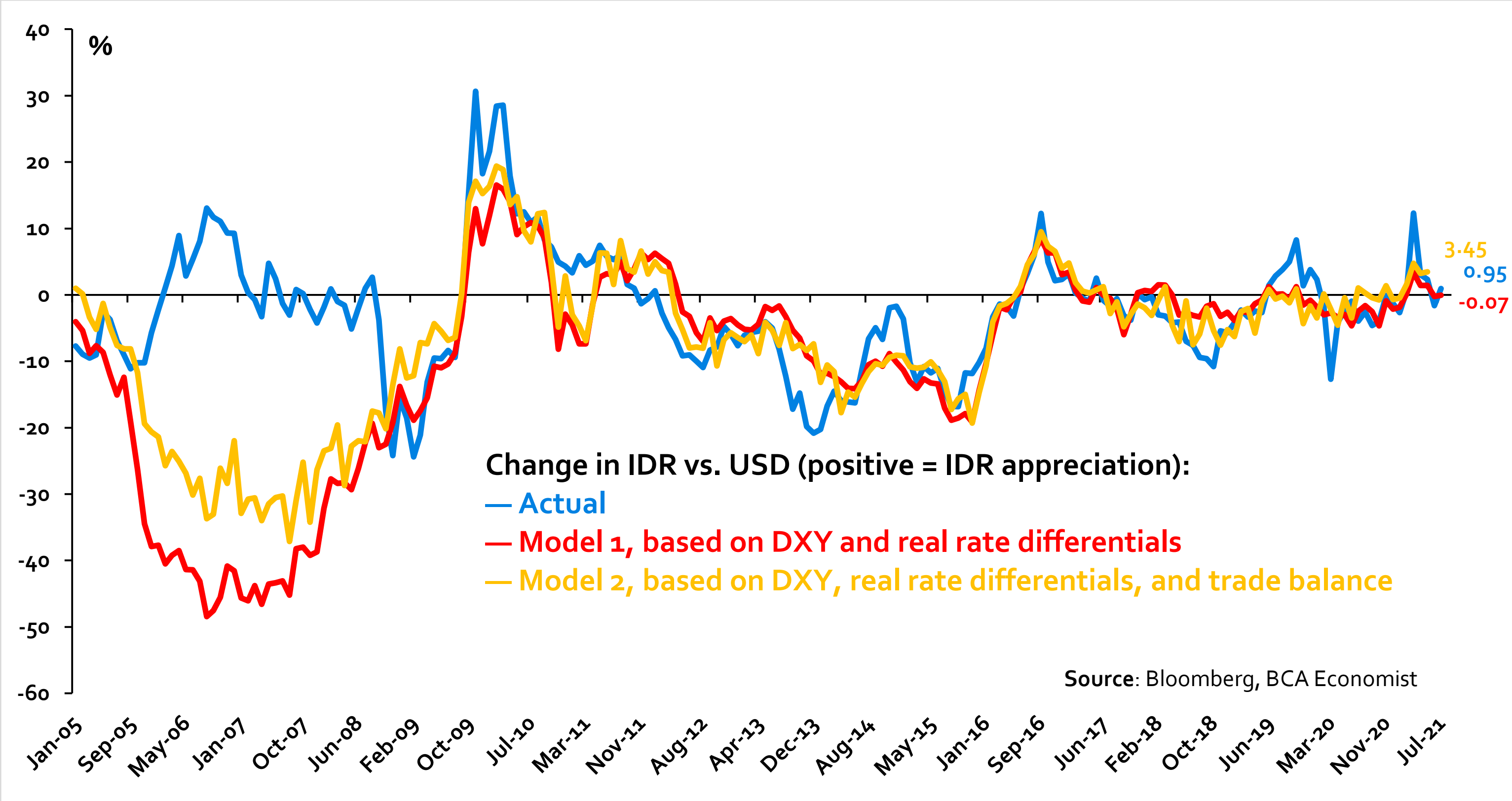
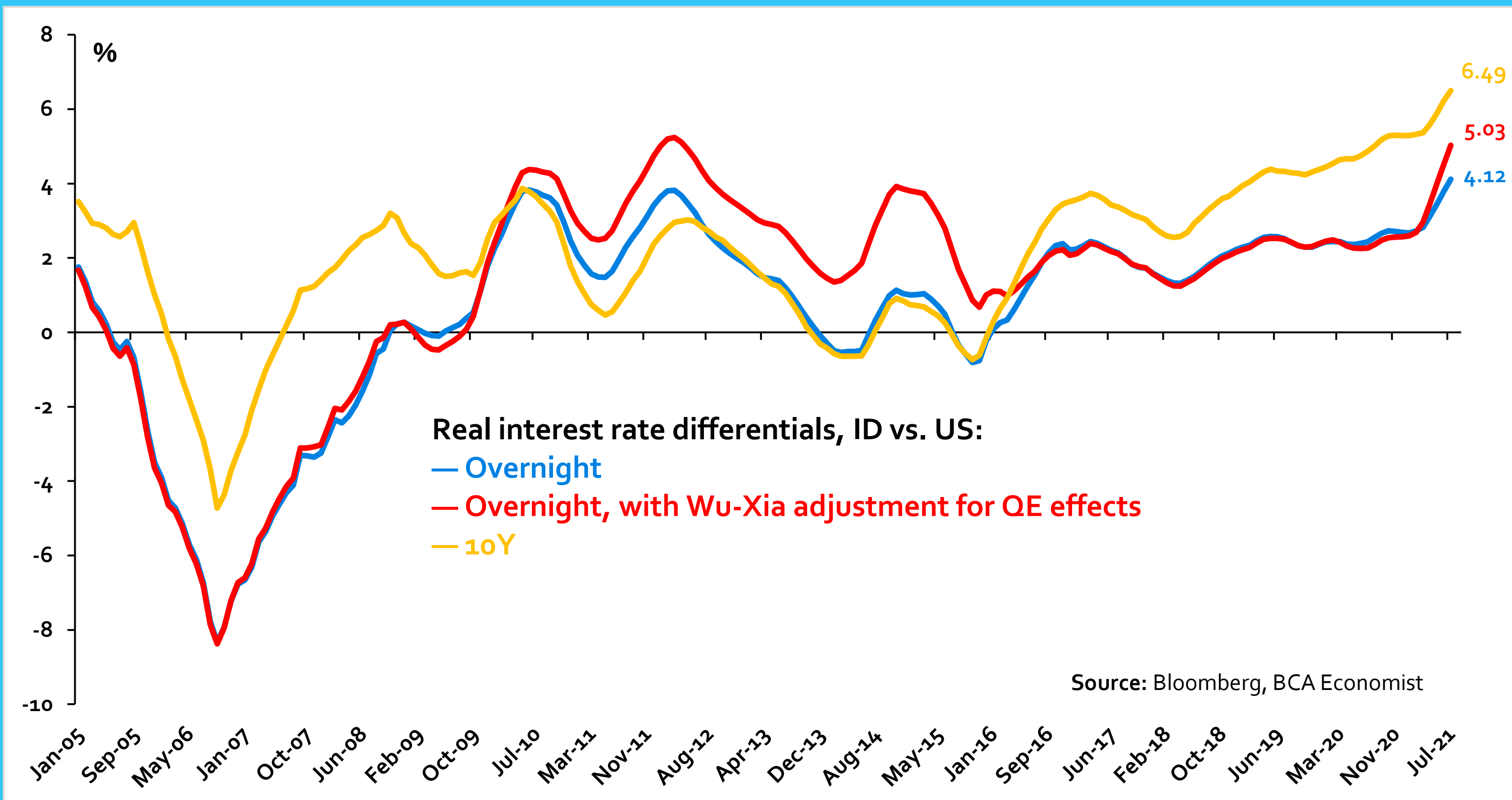


Chart 4. … and one of the main drivers, real interest rate differentials, are near all-time highs in recent months on account of rising US inflation



Selected Recent Economic Indicators

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	0.25	Mar-20	-5.15
UK	0.10	Mar-20	-2.40
EU	0.00	Mar-16	-2.20
Japan	-0.10	Jan-16	0.40
China (lending)	4.35	Oct-15	3.35
Korea	0.50	May-20	-2.10
India	4.00	May-20	-2.26
Indonesia	3.50	Feb-21	1.98

Money Mkt Rates	9-Aug	-1 mth	Chg (bps)
SPN (1M)	2.91	3.30	-39.0
SUN (10Y)	6.29	6.54	-24.3
INDONIA (O/N, Rp)	2.78	2.79	-0.8
JIBOR 1M (Rp)	3.56	3.55	0.9

Bank Rates (Rp)	May	Apr	Chg (bps)
Lending (WC)	9.02	9.08	-6.37
Deposit 1M	3.55	3.68	-12.21
Savings	0.80	0.80	-0.04

Currency/USD	9-Aug	-1 mth	Chg (%)
UK Pound	0.722	0.719	-0.39
Euro	0.852	0.842	-1.17
Japanese Yen	110.3	110.1	-0.14
Chinese RMB	6.486	6.479	-0.11
Indonesia Rupiah	14,363	14,528	1.15

Capital Mkt	9-Aug	-1 mth	Chg (%)
JCI	6,127.5	6,039.8	1.45
DJIA	35,101.9	34,870.2	0.66
FTSE	7,132.3	7,121.9	0.15
Nikkei 225	27,820.0	27,940.4	-0.43
Hang Seng	26,283.4	27,344.5	-3.88

Foreign portfolio ownership (Rp Tn)	Jul	Jun	Chg (Rp Tn)
Stock	1,936.9	1,893.1	43.85
Govt. Bond	947.3	977.3	-30.01
Corp. Bond	24.8	26.6	-1.78

Trade & Commodities	9-Aug	-1 mth	Chg (%)
Baltic Dry Index	3,371.0	3,300.0	2.2
S&P GSCI Index	512.5	531.8	-3.6
Oil (Brent, $/brl)	69.0	75.6	-8.6
Coal ($/MT)	148.0	119.5	23.9
Gas ($/MMBtu)	4.15	3.71	11.8
Gold ($/oz.)	1,729.9	1,808.3	-4.3
Copper ($/MT)	9,342.8	9,482.3	-1.5
Nickel ($/MT)	18,595.5	18,769.5	-0.9
CPO ($/MT)	1,067.1	954.8	11.8
Rubber ($/kg)	1.70	1.59	6.9

External Sector	Jun	May	Chg (%)
Export ($ bn)	18.55	16.93	9.5
Import ($ bn)	17.23	14.23	21.0
Trade bal. ($ bn)	1.32	2.70	-51.2
Central bank reserves ($ bn)	137.3	136.4	0.69

Prompt Indicators	Jul	Jun	May
Consumer confidence index (CCI)	80.2	107.4	104.4
Car sales (%YoY)	-	476.1	1,443.6
Motorcycle sales (%YoY)	-	155.1	1,065.7
Cement sales (%YoY)	-	36.9	14.7

Manufacturing PMI	Jul	Jun	Chg (bps)
USA	59.5	60.6	-110
Eurozone	62.8	63.4	-60
Japan	53.0	52.4	60
China	50.3	51.3	-100
Korea	53.0	53.9	-90
Indonesia	40.1	53.5	-1,340

Source: Bloomberg, BI, BPS
Notes:
*Previous data
For change in currency: **Black indicates appreciation against USD, **Red** indicates depreciation
***For PMI, **> 50** indicates economic expansion, **< 50** indicates contraction

Indonesia – Economic Indicators Projection

	2016	2017	2018	2019	2020	2021E
Gross Domestic Product (% YoY)	5.0	5.1	5.2	5.0	-2.1	3.6
GDP per Capita (US$)	3605	3877	3927	4175	3912	4055
Consumer Price Index Inflation (% YoY)	3.0	3.6	3.1	2.7	1.7	2.3
BI 7 day Repo Rate (%)	4.75	4.25	6.00	5.00	3.75	3.50
USD/IDR Exchange Rate (end of year)**	13,473	13,433	14,390	13,866	14.050	14.460
Trade Balance (US$ billion)	8.8	11.8	-8.5	-3.2	21.7	15.0
Current Account Balance (% GDP)	-1.8	-1.6	-3.0	-2.7	-0.4	-1.3

** Estimation of Rupiah's fundamental exchange rate

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