Inside Indonesia

OCBC Bank

Easy Easing

Indonesia cuts policy rate and reserve requirement

Feb 18, 2016

- **With tame inflation outlook on the domestic front and a stable currency despite global choppiness, it should not come as a surprise that Bank Indonesia decided it has the space to deliver another rate cut today.**
- **For good measure, it has also slashed the reserve requirement ratio for banks, with an eye on juicing up loans growth and also providing liquidity support to segments of the financial sector.**
- **The dovish stance is likely to persist and Indonesia is not done with the rate cut cycle yet. Combined with fiscal spending and progress on the structural reforms front, these make for triple treats that bode well for the economy.**

In Motion

Call it momentum. As physics has it, it takes a lot of force to get a heavy thing going. But once the object is moving, it tends to continue doing so and it will take another set of sizable opposing force to put a stop to the motion.

That is one way to see the policy rate movement that Bank Indonesia has orchestrated. While last month's first cut was momentous, taking place after a long period of deliberation about its potential negative impact and when the global market was still recovering from the renminbi jolt at the start of the year, this month's rate reduction is a lot easier to anticipate.

Domestically, while inflation print did pick up from 3.35%yoy to 4.14%, the real rate remains deeply positive even after the initial cut of the policy rate to the level of 7.25%. Globally, even as global markets remain in a rather flighty mode, Rupiah has been staying commendably stable and, if anything, capital inflows appear to have stayed resilient throughout. Tellingly, expectation for further currency depreciation has declined markedly. Despite the bouts of global turmoil, the implied hedging cost for USDIDR over 12 months has declined from over 13% in October last year and around 10% at the start of 2016 to below 9% of late. Essentially, both domestic and global signals are screaming "Yes, there is room to cut rate. Please use it." Hence, today's move by the central bank to shift policy rate down by another 25bps notch, bringing it to 7.0% can hardly be seen as a surprise.

For good measure, besides policy rate, BI has also cut its reserve requirement ratio, from 7.5% to 6.5% effective in mid-March. The move is slated to add as much as IDR34tn to the banking system, which would be helpful in pursuing the apparent goal of reaching loans growth of up to 14%yoy in 2016 this year, compared to 12.5% without the cuts. This is the first reserve requirement cut for the banking system since BI first brought it down from 8% effective November last year. It has been adopted most likely with an eye on how liquidity has remained tight in some parts of the financial system. Despite January's rate cut, for example, the 3-month JIBOR has remained relatively lofty at around 8.3% even if the shorter tenor 1-month interbank rate has come down more pliantly.

Treasury Advisory

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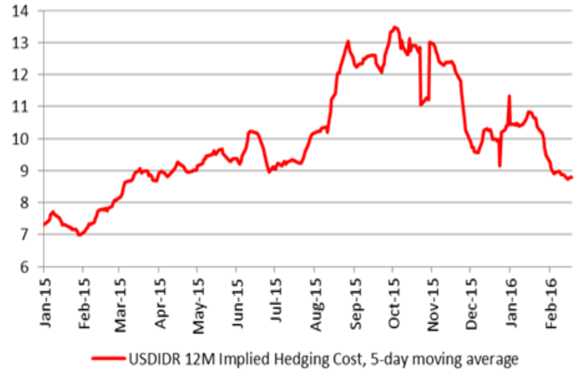
Tel: 6349-1886

Wellian Wiranto
Economist
Treasury Research & Strategy,
Global Treasury,
OCBC Bank

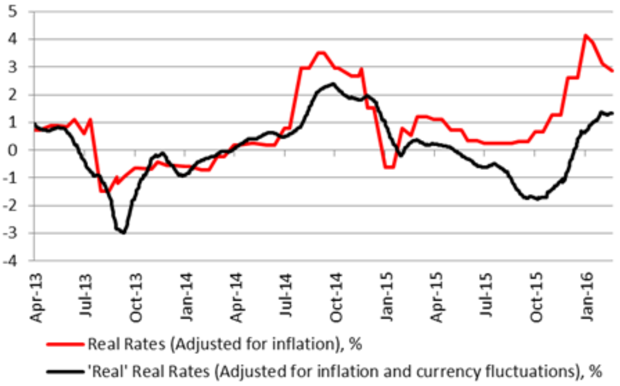
+65 6530-5949
wellianwiranto@ocbc.com

Fig 1. More relaxed about depreciation risk



Source: Bloomberg, OCBC.

Fig 2. Room to cut



Source: Bloomberg, OCBC.

Widodo's Wish

Now, with today's relatively aggressive easing moves, there is the obvious question of whether further easing measure is coming.

The question is a particularly interesting one, since the government continues to be keen to see further rate cuts and has hardly shied away from saying it out loud. For one, during an interview with Bloomberg last week, President Joko Widodo said that he would like interest rates "to fall, fall, fall, fall, and keep falling so the real sector can compete with other countries." If we were to mechanically count the number of times he repeated the word 'fall' there, obviously it signals that he is hardly satisfied with the two rate cuts thus far.

Such a wish from the political quarters aside, is there indeed an economic case for further cuts? A 'simple' answer is yes. After all, if inflation is indeed going to stay around 4% that the central bank aims for, we still have plenty of room southward. However, in an era where there continues to be so much global uncertainty, nothing is so simple. As we have pointed out repeatedly, BI would have to care for the fluctuations of capital inflows. Our measure of adjusted real rate, which takes into account hedging costs and foreign bond ownership levels, offers a proxy to account for such uncertainties. On that front, while there is space too – given that hedging cost has come down, as highlighted earlier – it is considerably less than the aggregate 3% space that traditional real rate calculation suggests.

We believe that BI is not done yet with easing. It has likely arrived at the conclusion that there will be a pushback in Fed funds rate hike, and is potentially judging that the resultant stabilization in USDIDR spot and forward market would therefore give them more room to cut rate than previously anticipated. Given this backdrop, we see a good chance that the near-term 'safe' rate is no longer 7.0% (i.e. no more rate cut from today) that we previously thought. We now think that BI may bring rate to as low as 6.5%– i.e. two more rate cuts this year. The next one may come as soon as next month. As usual, there is the caveat of relatively stable global sentiment that analysts have to throw in sadly.

All in all, Indonesia is on a roll. BI has obviously stepped into an easing cycle, with more rate cuts in the pipeline. Its room to do so has been helped massively also by the other two supportive engines of growth: fiscal and structural. As we mentioned in our Feb 5th report, "*Not Sheepish At All*," government spending is showing a strong momentum on the infrastructure front. No less importantly, the government's structural reform push – now in its tenth count of "stimulus measures" – appears to be gaining more traction too. Combined, the three make for a powerful mix in normal times but especially in a period where global investors are wary of global slowdown risks and concerned about how policymakers in general are running out of options to help. If Indonesia can show that it has the room across monetary, fiscal and structural fronts to get growth going, it will be a year whereby it can stand out from the crowd in a very good way.