Inside Indonesia

OCBC Bank

Booster Shot

Indonesia cuts rate on global slowdown concerns

Sep 22, 2016

- **Bank Indonesia cut its policy rate for the fifth time this year, trimming its newish 7-day reverse repo rate by 25bps to 5.0%, as expected by market consensus.**
- **Yes, Fed's non-move yesterday was a friendly supporting factor. But, underlying it all is something more sinister, which is the fact that global growth outlook appears to be growing more worrisome by the day.**
- **Already, such global concerns are affecting domestic loans growth in Indonesia, especially on non-Rupiah credit demand. BI's game thus remains one of goosing up supply of credit as much as it can within constraints.**

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Fifth Time Lucky?

After surprising market in the past few months in terms of monetary policy decision, Bank Indonesia finally gave most market watchers a reprieve today by cutting its policy rate as widely expected by market consensus. Too bad for us, then, who thought that BI might hold out a bit more as it awaits more concrete run-rate of the tax amnesty program.

Alas, as it turns out, the very fact that BI thought that the general environment is friendly enough for it to cut rate today can itself be seen as a sign of confidence that the program may be proceeding better than expected earlier. Indeed, there appears to have been a significant pick-up in the tax amnesty participation rate of late.

Going by the live dashboard provided by the Ministry of Finance, as much as IDR1441tn (~USD110bn) of assets have been declared thus far, comprising 36% of the government's target. As a measure of how quickly things seem to be turning up and around, when we checked the dashboard this morning, the reading stood at USD1300tn (~USD99bn). (Before we went on leave, it was IDR288tn on September 8th).

While much of the uptick must have been driven by the fact that the September 30th deadline for the first tranche of lowest penalty rate is kicking in and thus the take-up may peter off thereafter, it must have nonetheless be an encouraging sign for BI. Even if the government's target might still be too out-of-reach eventually, BI can at least take comfort that any miss is not going to be too distressingly so.

Apart from tax amnesty take-up, another area in which BI has paid attention to to gauge whether to trim its policy rate further has obviously been the trajectory of Federal funds rate.

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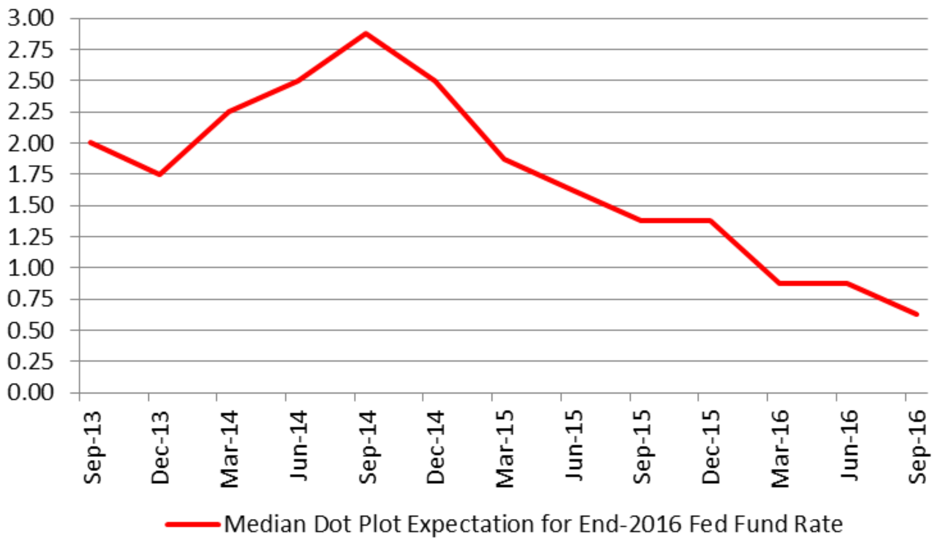
More than yesterday's decision by the FOMC to hold rate, we believe that it was the overall dovishness of the dot plot that would have given BI officials the most comfort that the chance that their counterparts in Washington, D.C. would choose to shock the market and raise rate hastily is a relatively low one. From projecting Fed Funds rate to end 2016 at nearly 3.0% in late 2014 to now just seeing it at 0.625 (i.e. just one hike from here), the median dot plot has come a long way. From the perspective of central bankers of Indonesia (and no doubt, other EMs), this has inadvertently opened up space for them to do what they think is needed for their economies without having to watch their backs all the time.



Source: Bloomberg, OCBC.

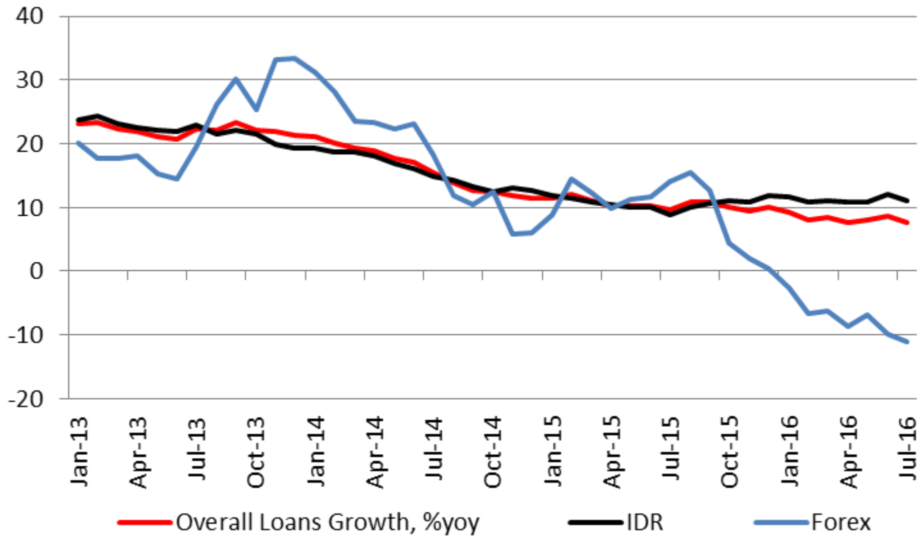
Still, even as officials at BI may take comfort in the notion that the Fed is not going to hurry in raising their interest rate, any joy that might be had there is nevertheless going to be limited. That is because, the lack of growth momentum in the US is the key reason why the Fed cannot raise rate – and in turn, that has implications for even the relatively insular economy like Indonesia's.

Indeed, BI's policy statement as well as press conference helmed by its governor, Agus Martowardojo, spoke uncharacteristically in lengths about global growth concerns. For one, the statement highlighted how "Global economy could potentially grow less robustly than previously predicted, with significant drops in trade volumes." US economy, it says, "is likely to grow by less than previously anticipated, with weak investment." Similar downbeat tone can be felt when BI spoke about prospects in other key economies such as the EU and China.

On the surface, such focus on global slowdown risk may be curious for Indonesia, whose domestic consumption makes up more than half of its economy. However, looking at the linkages, especially via its lacklustre domestic credit growth, it all makes sense.

Boosting its domestic credit growth has long been one key reason why BI has been cutting rates this year, by as much as 4 times amounting to 100bps even before today's 25bps cut. Here, however, it has seen only mixed success. While deposit rate has indeed come down by around as much, loans rate has not followed suit much, only dropping by around 52bps, going by the press conference. It appears that the lack of credit demand remains the issue, and BI is right in pointing out that a lack of domestic confidence regarding global growth prospects has probably played a key role.

This is especially evident when we look at the growth rate for foreign denominated loans in Indonesia. While the Rupiah-denominated loans have started to pick up somewhat of late, loans denominated in foreign currency have continued to be shrinking, dampening the overall loans growth rate for the economy. To be sure, other factors including concerns about sudden Rupiah depreciation risk may have played a role, but the lower global trade volumes would have mattered too.



Source: CEIC, OCBC.

Facing such global concerns, BI looks set to continue focusing on juicing up domestic credit growth. To make up for the lacklustre loans growth that is driven by external factors, including growth of foreign currency-denominated loans, it has little choice but to continue trying to boost demand for Rupiah credit growth. Here, even after cutting its policy rate by 125bps effectively, we think there is a good chance it would go further along the easing path by trimming rate at least one more time by end of this year.

The presence of low inflation, friendlier current account deficit, as well as encouraging take-up of tax amnesty of late would be supportive domestic factors. On the global front, BI would continue to watch out for any sign of sudden risk off environment that threatens Rupiah stability and thus crimps their r to cut rate. While a sudden hawkish turn for the Fed – with more than one hike this year – technically remains a possibility, that is a remote one for now in that regard. Still, the potential of market reacting badly to November 8th US presidential election results illustrates how risk-off can happen without a hawkish Fed.