Indonesia

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Good Enough Now?

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Bank Indonesia reached for monetary easing

- Last month, growth was already weakening, and Rupiah was already strengthening – increasing the need for BI to ease and its space to do so. But it was not strong enough for them to act back then, partly in view also of the need to anchor stronger bond fund inflows through rate differential.
- By now, we have reached a tipping point. Growth outturn is bad enough for BI to trim its growth forecast, and Rupiah has indeed strengthened further since and stayed relatively well-anchored; a greater need combined with a greater space to do something – and it did. BI cut its policy rate by 25bps.
- Going forward, this is still a dovish central bank, and one that will be keen to cut rate further, potentially in the next meeting if global market cooperates. As and when it cuts next might also be when it cuts for the last time. With the need to preserve yield differential still paramount, 4% should be the terminal rate for Indonesia in the near term.

Looking Forward, Looking Back

In responding to Bank Indonesia's decision last month to keep interest rate unchanged, we titled our report "Not Good Enough", summarizing our sense that even though BI was happy to see the Rupiah gains, it was not sufficiently robust enough yet for it to relax and cut rate.

Hence, perhaps it is fitting then to ask if BI's decision to cut rate today – bringing its policy rate down by 25 bps to 4.25% - has been driven solely by the notion that, now that Rupiah has strengthened further, crossing below 14000 against the USD recently and now staying just above that line.

In and of its own, the Rupiah performance appears to have been a necessary and insufficient condition. The other key ingredient has been the relatively greater need to do something to help growth.

After hugging the 2.3% baseline forecast for a while, the government has relented and acknowledged the economic outturn so far has been poor enough to warrant a downgrade to a more realistic 0-1% range, as mentioned by Finance Minister Sri Mulyani a few days ago. Our own take is that growth may dip to 0.4% this year, given the deeper-than-expected Q2 downturn.

Today, the central bank which was communicating the same headline numbers as the government previously, has also chopped its 2020 outlook, albeit less drastically than the government did, to 0.9-1.9% range. Judging from the press conference, the Governor's tone does not seem overly pessimistic about the outlook, however, with talks about how growth pressure has eased in some corners.

If anything, it appears that the vast portion of the growth downgrade has been driven by the fact that the economic outturn – thus far – might have been sizably worse than they had anticipated before. Hence whatever has happened thus far in Q2 has depressed their 2020 outlook more, even as it was stressing that a nascent recovery is now taking place on both global and domestic fronts.

Its MPC statement (as translated from the Bahasa version), for one, mentions that Q2 growth is expected to decline, but early indications suggest that economic pressure has eased. It cited how cement sales, retail sales, PMI and consumer confidence have shown recovery in May, compared to April. Interestingly enough, it also signalled that May's exports – which surprised market expectations on the low side overall – might have nonetheless come in better than BI had expected, citing improvement in demand from China. Going forward, the MPC statement highlighted that it expects to see growth momentum improving in Q3 as social distancing measures are relaxed and the effect from the fiscal stimulus package kicks in.

Despite the relatively constructive outlook that it has in H2, the scale of the downtick in H1 and especially in April and early May has nonetheless prompted BI to assess that there is a greater need to act today just as it did.

No less importantly, BI has also appeared to be comfortable enough with the global market sentiment to ease, as we gather from the governor's speech and the MPC statement. The latter, for instance, mentioned that the factors such as global PMI improvement has "reduced global financial market uncertainties and drove global capital inflows into EMs and reduced exchange rate pressure on developing markets, including Indonesia."

Conspicuously absent this time round is the focus on lingering global market uncertainties and hence the predominant need to anchor fund inflows via preservation of interest rate differentials that BI alluded to in the last MPC meeting.

Still, even as we think this is a dovish central bank that wants to cut rates further – and may well cut one more time next month if global market sentiment allows it, we reckon that the need to preserve the yield differential is never going to go away anytime soon.

Indeed, the next 25bps cut that it undertakes will most likely also be its last one for a while. We do not think it is comfortable in cutting rate beyond 4%. There remains a keen structural need still to preserve yield differential to attract foreign bond inflows. This is especially so at a time when the need to source for foreign bond inflows to plug the fiscal deficit has gotten ever greater.

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