Indonesia

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Poised to Pause

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Why Bank Indonesia will hold its policy rate for now

- Indonesia's central bank will announce the decision from its meeting tomorrow – the second last for 2019 – and we expect it to be on pause, after four consecutive rate cuts worth 100bps in aggregate.
- Inflation prints are contained, current account gap is in check, and most importantly, Rupiah has been broadly well-behaved. Together, this should technically still give BI some room to ease further – if it so chooses.
- However, given the increasingly binary outcome of US-China trade negotiations, prudence is BI's top operative word from now. The last thing it wants is to be forced into a sharp U-turn later. Best to take it easy from here.

Mulling the middle

Having eased its policy rate four times this year, Bank Indonesia has earned the right to pause in the upcoming meeting, and our sense is that it will indeed hold rate unchanged at 5.0% for the rest of the year.

Let's start with the consideration on whether there is a strong need to ease further. While the recent Q3 GDP data has a lacklustre air to it, the momentum has not slowed enough to justify another rate cut this week. As mentioned in our Nov 5th report, boosting growth on a more sustainable basis has less to do with further monetary support and a lot more to do with structural reforms by the government, particularly on labour law changes to address a key FDI impediment.

In other words, BI has done what it can in putting a floor on growth through its 100bps cut already. Opting for further easing would have limited beneficial effect on growth. Moreover, the marginal cost of further easing is starting to be higher from here, given that the current policy rate setting leaves it in the relative sweet spot of maximizing future manoeuvrability on three counts.

Measure	Latest	*From 2017 to latest*		
		Average	Min	Max
Nominal Rates	5.00	5.10	4.25	6.00
Real Rates	1.87	1.73	0.38	3.52
Rate Differential	3.38	3.46	2.63	4.13

Note: Real rates refer to the difference between BI's 7-day reverse repo policy rate and contemporaneous headline CPI inflation rate. Rate differential refers to the gap between Indonesia's policy rate and the midpoint of US Fed Funds rate.

To start with, in nominal terms, the current level of 5.0% is broadly in the middle of the range of the policy rate since 2017, encompassing the period before the central bank was compelled to start hiking rate in May 2018 from

4.25% all the way to 6.0%, due to broader emerging market concerns as the Fed's tightening cycle gathered pace.

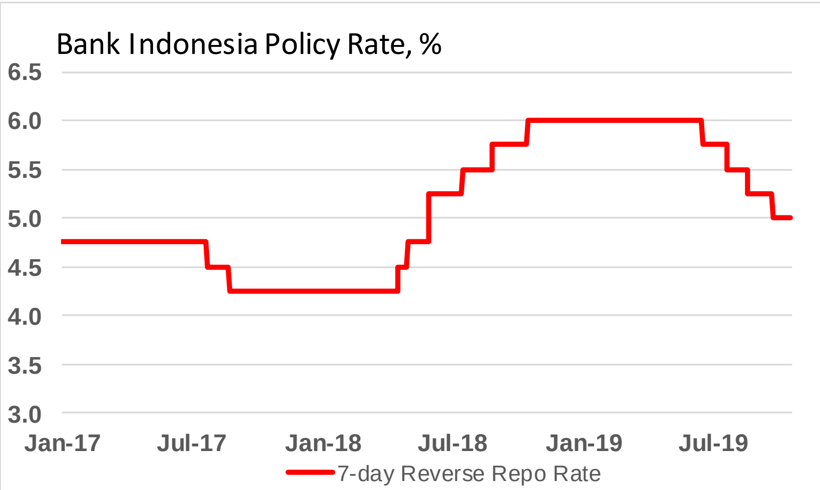
Taking the view that the policy rate setting might have been relatively too loose before the onset of 2018 market concerns – necessitating the dramatic tightening response – and that, at its height, the monetary policy might have been overly tight, the halfway point might be an useful rule of the thumb.

The same thinking applies when we look at how the prevailing policy rate fares against domestic inflation rate and versus the Fed funds rate. Both the real rates and differential against the US policy rate are now close to the period average. The former signals that the current rate setting is "just nice" in curbing domestic inflation pressure, and the latter in anchoring interest rate differential that is attractive enough to foreign investors.

In particular, with rates differential preservation in mind, given that the Fed has been actively telegraphing to the market that it is not in a hurry to trim rates further after its 3 rate cuts this year, there is a compelling reason for Bank Indonesia to follow suit with a pause as well at this juncture.

Being in the middle on all three counts maximizes the room for Bank Indonesia to manoeuvre going forward.

If growth momentum slumps significantly enough in 2020 to necessitate further monetary action, it can be more assured that it has preserved this space. On the flip side, in the (unlikely) case of sizable pick-up in domestic inflation or the (less unlikely) case of global market volatility which might require sudden rate hikes to anchor currency stability, the degree of upward policy rate reversal that it has to stomach will be contained, as well. In short, a pause now is very much in the order.



Source: OCBC, Bloomberg.

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