OCBC TREASURY RESEARCH

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Last of the Lot?

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Let's hope that Indonesia's rate cut today is the last

- Bank Indonesia cut its policy rate by 25bps to 4.0% as we expected, and broadly in line with majority of market anticipation. Today's cut also marks the lowest point at which the 7-day reverse repo rate has been, since it was adopted by the central bank as the main policy rate in 2016.
- While the governor noted a relative improvement in the month of June across a host of economic activity indicators, the prospect of further hits is not far from his mind. Indeed, he signalled that a global virus resurgence threatens to nip the recovery in the bud, in part by dampening the effectiveness of various stimulus measures that have been adopted.
- Going forward, having cut by 200bps already in this cycle, BI's space for further easing would naturally be more limited to start with. Moreover, yield differential remains important in anchoring bond inflows. Hence, unless growth deteriorates considerably, BI would much prefer to sit pat for a while.

A low-point

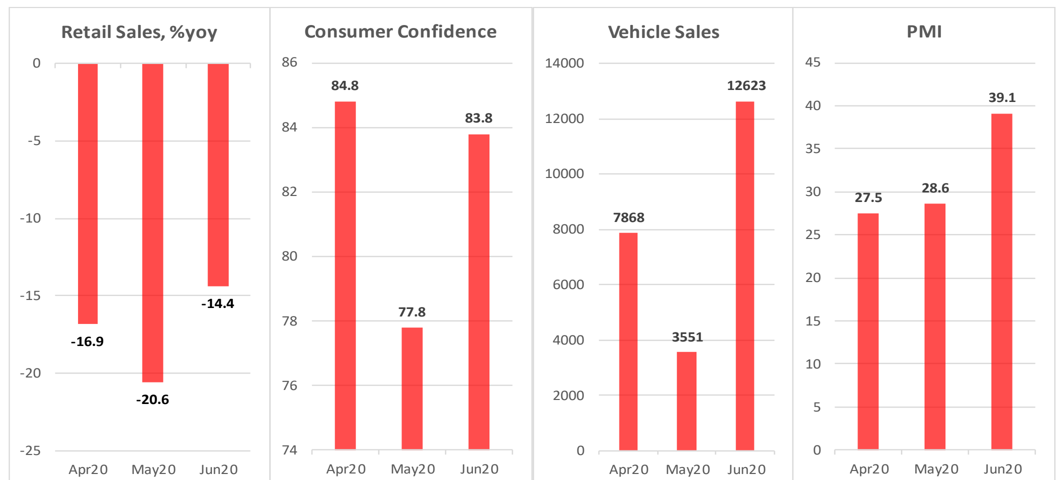
Going into today's meeting, we must admit that the recent Rupiah depreciation due to global uncertainties did make us wonder whether our expectation for a rate cut by Bank Indonesia would turn out to be right.

As it turns out, while BI did note the presence of factors, including US-China geopolitical tensions contributing to a less favourable environment for EM currencies including IDR, it was ultimately the need to help egg Indonesia's growth along that proved to be the greater determinant. It cut rate by 25bps to 4.0% - the lowest it has been since the 7day reverse repo was adopted as the main policy instrument in 2016.

Source: OCBC, Bloomberg.

For one, BI noted that the quarter that has just passed, Q2, is likely to see Indonesia reporting a contraction of 4% yoy (in line with our expectation). Meanwhile, the government has warned that the economy might have shrunk by an even deeper 5.1% during the period. The data will be released officially on August 5th, and whatever the print will be, it would easily mark the lowest point for Indonesia's growth since it endured the brutal days of the Asian Financial Crisis in 1997-98.

To be fair, BI did note that, as much as the pullback in economic activities was dire for the quarter as a whole, if we look into the momentum coming out of it in the month of June, things did look to be on the improving end. Across four relatively high frequency indicators, from retail sales and consumer confidence to vehicle sales and PMI readings, June saw sizable improvement from the earlier part of the quarter, for instance.



Source: OCBC, Bloomberg.

Still, in a convoluted things-were-really-bad-and-then-getting-better-but-things-might-get-bad-yet-again warning similar to the one signalled by its Malaysian counterparts recently, Indonesia's central bank has also noted a whole swathe of downside risks, especially on the global front.

From the governor's speech and the (Bahasa) MPC statement alike, BI said that it expects global economic contraction to continue, and for the recovery process to take longer than it had previously anticipated. It noted the uptick in covid-19 cases, with the overall fear of virus resurgence limiting how effective the stimulus measures that have been adopted by developed and emerging markets alike can be in juicing up global economic recovery.

Hence, to provide some further buffer against both the damage that is already wrought by the virus and the potential future hits that might well come soon, Bank Indonesia opted to cut rate today.

Now, having crossed over to the historic-low level of 4.0% now, the obvious question is: Are we done yet?

And, our short answer to that is: We hope so.

First of all, no matter which way you cut it, 4% policy rate is low by Indonesia's standards. While inflation has been low (at just below 2%, the lower end of BI's target range) and is likely to stay low (given tepid consumer demand), the real rate buffer of around 2ppt is not a very thick one.

Even though we agree with BI's repeated insistence that inflation is not a 2020 story, the unprecedented size and mechanism in which BI would increase its balance sheet to help fund the government's gaping fiscal deficit means there remains a risk that inflation can rear its ugly head unexpectedly in 2021. The less buffer it has now, the sharper the upturn in policy rate will have to be potentially when the chicken comes home to roost – and the greater the pain will be felt by the economy.

Secondly, Indonesia remains dependent on foreign inflows to help fund its current account deficit, even as the gap may be lower now than before due to lower trade deficit as imports shrink. While the roping-in of BI as the 'anchor investor' for government's deficit financing helps to reduce the need for foreign funding as well, it is by no means a mechanism that can be depended upon exclusively without sacrificing the country's hard-won macroeconomic stability. To that end, as we mentioned before in our June 12th report, the gap between Indonesia's policy rate and that of the Fed remains a key determinant of bond fund inflows.

Last but not least, our thinking that today's cut will be the last one for the cycle is really predicated more on hope rather than analysis: hope that the global virus resurgence fears prove to be unfounded, such that the nascent economic recovery that we have seen in Indonesia and elsewhere will not be nipped in the bud by it. And we should not pretend to have a model – economic, epidemiological or any others – that can tell us with good certainty that we can get things under control soon enough for us to dismiss the risk totally.

To be sure, if the pandemic situation worsens enough such that the global economy may enter into another dramatic fall, then BI might have little choice but to tackle the immediate danger by cutting its policy rate further. We can only hope that we will not come to that.

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