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Inside Indonesia

Toolkit Tinkering
Indonesia is reportedly fine-tuning its policy rate framework

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- **Media reports suggest that Bank Indonesia may be adopting 7-day reverse repo rate as its new benchmark policy rate, to better reflect and affect money market rates. The shift is to be effective in August supposedly.**
- **Looking back, such a move should not be too surprising given BI's emphasis on "strengthening operational framework" in its recent policy statement and its active shepherding of term structure since the start of the year.**
- **The new framework should help BI to strike two birds with one stone: structurally deepening money markets with its active presence at the short end, while cyclically aiding the transmission process of its rate cuts thus far.**

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It's in the news

Bloomberg broke the news first on Tuesday afternoon. In its article, "*Bank Indonesia Said to Adopt Reverse Repo as Benchmark Rate*," it mentions that the central bank is planning to overhaul its primary monetary policy tool, by shifting from its current reference rate to a 7-day reverse repo rate as the new benchmark. A Reuters report added that the change will be announced on Friday, citing BI's senior deputy governor, Mirza Adityaswara.

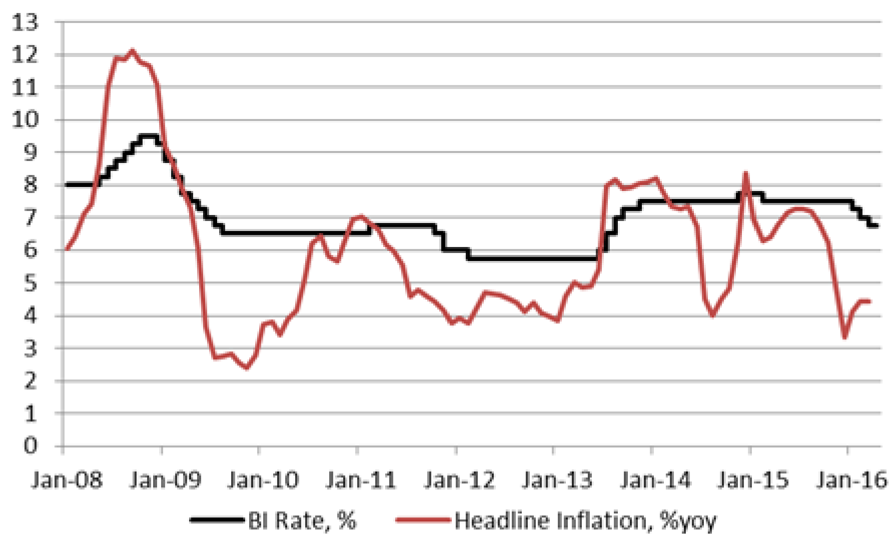
Below is a series of what we thought might be frequently asked questions related to the potential move:

Q1. What is the current framework to begin with?

The current framework uses 12-month BI policy rate as the benchmark rate. It was adopted in July 2005 when the central bank formally embraced inflation targeting. Prior to that, BI operated its monetary policy by looking at base money. This was essentially a quantitative targeting system based on the amount of money available in the system.

A policy rate anchor was adopted then to better provide guidance to the public on inflation expectations. Without a policy rate as the anchor, in BI's own words on its website, "there can be no clarity on what direction monetary policy is taking, and the public then has nothing to guide their expectations of inflation. This is akin to a ship adrift at sea, with no clear direction to the next port."

Viewed in the context of inflation targeting framework, the 12-month tenor of the policy rate since 2005 would have been a natural choice, as it matches with the 12-month perspective in which inflation is reported. To that end, the central bank has achieved considerable success in recent years in using the policy rate in bringing actual inflation within its targeted range, as well. In this, some credit is also due for the Jokowi government which boldly abolished the fuel subsidy scheme in November 2014 and thus removed one of the biggest bugbears of monetary policy credibility which was the tendency for Indonesia's inflation to spike up to double-digit territory whenever the government was forced to kowtow to ballooning fuel subsidy bills and raise fuel prices suddenly.



Source: Bloomberg, OCBC.

Hence, any shift away from the 12-month tenor for the policy rate is also implicitly a signal of BI's confidence that the fuel subsidy removal is set in stone and that the super-volatile inflation rate is a thing of the past.

Q2. Is this going to be a drastic change?

No, the upcoming shift is not so much a total revamp of the policy framework as a fine-tuning operation. For one, it looks like the central bank is still a keen adopter of the inflation targeting framework that has been in place for over a decade now. That does not go away. Moreover, from what we gather, the idea of using a benchmark rate as the anchor for its policy signalling is still very much in place.

What seems set to be changing, however, is that instead of focusing on the 12-month tenor as of now, BI will reportedly start to use a 7-day tenor one instead. Hence, if the news reports turn out to be true, come August, when we talk about BI rate, we would essentially be referring to the new 7-day rate, rather than the current 12-month one.

Q3. Is this monetary policy easing by stealth?

No, not at all.

The change in the tenor of the benchmark rate does not change the monetary policy stance of BI in and of its own. The risk of misunderstanding is there, given that the current 12-month target rate is set at 6.75%, whereas the actual 7-day rate has been staying around 5.5%. The shorter tenor rate is naturally lower than the longer tenor one just because of the way any yield curve works in general as it builds in time value of money, inflation expectations and such.

One way of reading the move would be to say that BI has cut rate by a massive 125bps in one go. That is too simplistic and, as it happens, a wrong interpretation.

Even with the fine-tuning of framework, it is still the same monetary policy stance. What is changing is merely the portion of the curve in which the central bank will be focusing on. Ideally, that would be the key message to be communicated to the market as and when the framework shift is rolled out by BI.

Indeed, to emphasize the fact that there is no so-called stealth rate cut or shadow easing of any kind, we think it will be highly unlikely that BI would undertake any monetary policy easing from now until the new policy rate is effective and functionally steady. Keeping the monetary policy stance unchanged during the transition period and soon after the actual handover would help ensure that the risk of

misunderstanding is minimized. Cutting the target rate even as the very idea of what constitutes the target rate is changing is simply too confusing and too risky a move.

If August is truly the effective date, then we are talking about at least a month of two thereafter, before BI is to think about easing its (new) policy rate, and that is provided that global market conditions are seen to be stable enough. With so many event risks mid-year, including Brexit vote, potential Fed fund hike, and probable nomination of Donald Trump as the Republican presidential candidate, stability in global market then cannot be taken for granted.

Q4. Why Seven?

As of now, the current policy rate is first and foremost a signalling tool to affect inflation expectations as discussed earlier. Moreover, the 12-month tenor limits its operational significance, because even though there is technically a 12-month interbank market, it is marred by illiquidity. This is partly because banks go to the interbank market to borrow from their counterparts for short-term liquidity management needs, such as fulfilling reserve requirement ratio, rather than for longer term purposes.

For the same reason, the short end of the interbank market is thus a relatively more vibrant one, with overnight tenor being most liquid. Technically, in looking for a new rate to target, BI could have chosen the overnight interbank lending market. However, any decision to actually target the 7-day tenor is probably driven by the fact that the overnight rates are too volatile, especially close to period ends when some banks might bid up the rate, to secure enough funding to fulfil regulatory requirements. The deviation of actual market from the target policy rate may thus be deemed too unwieldy for the shortest end.

The 7-day tenor is thus effectively a compromise between wanting to affect the operations of money markets at the more active part of the curve and minimizing the deviation of actual rates from the targeted policy rate. Targeting the longer tenor ones is ineffective given the interbank market dynamics, while using the shortest-end overnight rate as the target runs the risk of too much operational deviation at times.

Q5. How would the new policy rate affect interbank rates, exactly?

The new channel would be via the repo market.

If the central bank, eventually, decides to cut its policy rate, in essence, it is saying that it will be targeting a lower interbank market rate.

Now, to achieve that, it is not that the central bank would participate in the interbank market directly, since it is a market exclusively for transactions between banks. However, it can still influence the rate there by changing the rate at which it transacts directly with individual banks on its own.

This is done via reverse repo operations, in which the central bank receives money from the banks, while offering them some collateral. The transaction is reversed in seven days, as per the targeted tenor, with no net change in ultimate positions except for the fact that the bank will get some interests on top of the original amount of money that it gave to the central bank. That interest is currently at 5.5% per annum. In the event that the central bank opts to cut its policy rate by 25bps, the interest rate that banks would get from BI's reverse repo transactions would thus decline by a corresponding amount to 5.25%.

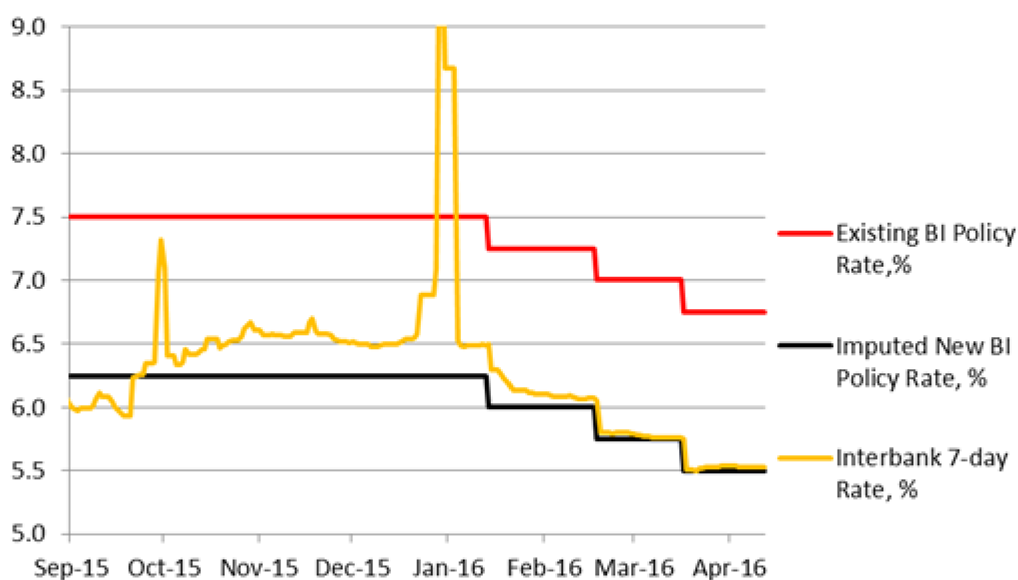
In turn, since banks would thus receive lower interest from transacting with the central bank this way, the idea is that they would thus also charge other banks less to borrow from them. Thus, the interbank lending rate, which aggregates how much banks charge one another to borrow for the particular tenor – in this case 7 days – would decrease, as well.

Q6. How has BI been preparing the market for this?

Let's start with what the central bank has been formally saying in its monetary policy statements.

In February when it cut rate for the second time of the year, it started flagging its focus on money market's term structure, saying that "to further support the policy rate easing, the term structure are also lowered, in line with liquidity conditions in each tenor." For good measure, a month later, in the most recent monetary statement on March 17th, it said that "To enhance the effects of policy transmission, future focus on the short term are on strengthening operational framework through a consistent term structure of monetary operations."

These words were strongly backed by action, as well. Since the start of 2016, BI appears to have been actively engaging in the reverse repo market to shepherd the previously rather unwieldy 7-day interbank rate (the yellow line in the chart below) to a certain level. That level is where the likely new BI policy rate (black line) would have been if it had been adopted earlier. In this, we have presumed a constant 125bps gap between the current BI policy rate (red line) and its successor.

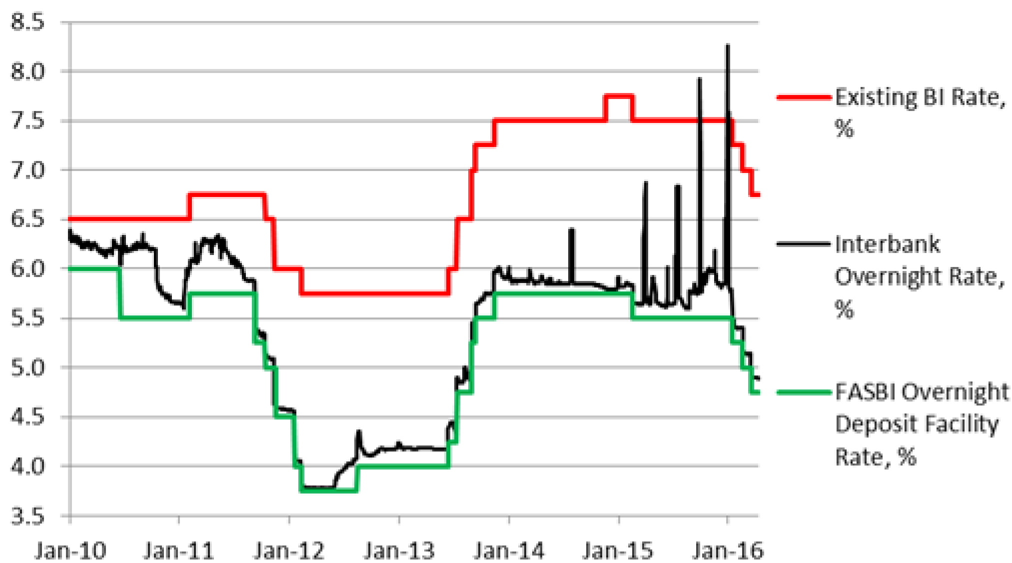


Source: Bloomberg, OCBC. Note: The imputed new BI rate assumes a constant 125bps gap between the existing BI rate and its potential successor, 7-day reverse repo rate.

Such preparatory work is done perhaps both to prepare the money market for the adoption of new benchmark rate and also to strengthen BI's own institutional capability in carrying out the open market operations behind the scenes. To further ensure a smooth process, it appears that BI would also mandate a transition period lasting a few months before the new benchmark rate fully takes over in August, as press reports suggest.

Q7. What happens next to the FASBI rate?

For the benefit of those who do not breathe Indonesia's money market terms day in and day out, FASBI rate is the deposit facility rate – the rate at which banks can put their excess liquidity at the central bank on an overnight basis. Over the years, it has been acting as a floor for Indonesia's interest rate corridor, with overnight interbank rates meandering towards and largely hovering just above it.



Source: Bloomberg, OCBC.

Our sense is that the FASBI rate will be maintained as it is in the new framework, and that it will stay at the current level of 4.75%. This means that it will retain a gap of 2 percentage points against the old benchmark rate and 75bps versus the new benchmark rate.

FASBI rate would thus continue to serve as an anchor for the overnight interbank rate, the same way that the new benchmark 7-day reverse repo rate would guide the 7-day interbank rate. Together, the two would thus joined forces and act as signposts towards which the shorter end of Indonesia's money markets would move towards.

Q8. Why all the emphasis on money markets?

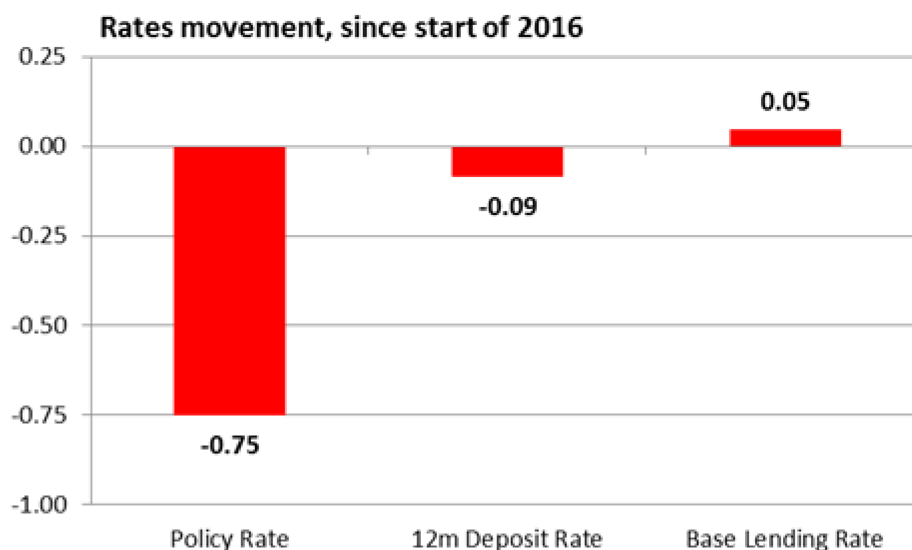
Going by press reports, one key aim of the policy fine-tuning is to help develop Indonesia's money markets and thus aid monetary policy transmission. Cogencis newswire, for instance, cited a BI official as saying that "With short-term monetary instrument, the monetary transmission will be more effective." It also added that the turnover in Indonesia's money market ranges between USD4-5bn per day, "less than half of Thailand's $11bn and Malaysia's $13bn."

Now, how would BI's purported decision to move the focus of policy rate help to develop the country's money market? The short answer is, simply, by being there.

As mentioned above, the FASBI rate has been serving as the anchor-point for overnight interbank rates thus far. It is about to be joined by the new benchmark rate which would serve as a reference point for 7-day tenor. Further up the curve, BI has also been busy engaging in reverse repos at the 14-day and 1-month tenors, with rates of 5.6% and 5.8%, respectively. The end game would probably be a functioning reference curve that goes up the tenor further and serve to guide interbank lending along as well.

Separately, BI is probably going to continue improving the infrastructure of a better functioning money market by getting more and more banks to sign up to repo agreements. Cogencis reports that it had already introduced reverse repo pact between itself and banks in 2008, but the take up for master repo agreements between banks remains low at 46 (out of 118 banks in total).

All in all, BI's goal is to see a better environment for monetary policy transmission, that any upward or downward shift it makes to its policy rates would bring about corresponding moves in the rates at which banks charge businesses and consumers for loans.



Source: Bloomberg, OCBC.

The adoption of a new benchmark is thus probably motivated in part by the fact that even though BI has cut its policy rate by 75bps this year, not much of that has transpired to bank rates, with deposit rates down by less than 10bps and lending rates actually up a tad. By having a new benchmark, which should help to boost liquidity in money markets, to offer reference rates across the tenor and thus facilitate bank-to-bank lending.

The last bit is an especially important piece of the overall jigsaw puzzle. As a whole, Indonesia's banking system actually sits on pretty flush liquidity, with excess reserves amounting to over IDR4tn. But its distribution appears to have been concentrated heavily among the bigger banks, with their smaller counterparts more starved of liquidity. By getting more banks to lend to one another more, the distribution should become less skewed and facilitate more loans disbursement in aggregate.

Q9. I have seen a lot of colourful charts and way too many dour words. I still don't quite get what this is all about. Can you summarize it all in one paragraph please?

News reports suggest that Bank Indonesia is about to announce a new benchmark policy rate tomorrow, that will be effective in August. The previous 12-month policy rate is no longer potent given inflation is less of an issue now than before. Its possible successor is the 7-day reverse repo rate, which would allow BI to play a more direct role in interbank market. In turn, this should get the money to circulate more freely between banks – and thus ultimately facilitate more lending by banks to consumers and businesses. In short, credit growth should improve and so should economic growth in the longer run.

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