OCBC TREASURY RESEARCH

OCBC Bank

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Not Good Enough

Wellian Wiranto
+65 6530 6818
WellianWiranto@ocbc.com

Bank Indonesia held rate unchanged despite recent Rupiah strength

- Although Rupiah has breached and stayed below the 15000 level against USD that BI has touted as its year-end target, the central bank has been hesitant in 'taking profit' – to use the space to cut rate further today.
- Given the weak Q1 growth and likely even weaker momentum since then due broader covid-19 outbreak and impact, the case for a cut to help growth has clearly risen of late. Hence, BI's reluctance to ease is even more stark.
- The government's announcement yesterday of a further ballooning of fiscal deficit to 6.27% of GDP might have tipped the balance today. With greater funding needs comes a more pressing need to preserve yield differential.

Despite the Need

As we detailed in our 5 May report on Indonesia's Q1 GDP, the significant downside surprise then, and the likely continued downward economic momentum now, would have ratcheted up the pressure for Bank Indonesia to cut rate today.

This has been especially so, given the recent relative strength in Rupiah. Indeed, for much of the month of May so far – save for two days – USDIDR has stayed below the 15000 level that BI has been touting as its year-end target.

Source: OCBC, Bloomberg.

Given the greater need to cut rate (due to weak momentum) and the window of opportunity (due to cooperative currency), today's decision to hold its policy rate unchanged at 4.5% has come as a surprise to us, and most in the market.

Having left scratching our head on why, we have obviously looked to today's press conference and published MPC statement (both in Bahasa for now) for some clues.

Let's start with its outlook on growth. While it acknowledges that Q1 GDP growth was a miss, BI was quick to point out the others might have had it worse with negative prints – most likely with domestic audience in mind.

Still, in the press conference, the governor hinted that the growth outlook is now worse than previously anticipated. He might have demurred from offering new growth forecasts, likely with camaraderie with the government's baseline growth assumption of 2.3% in mind for now. However, the acknowledgement that retail sales survey results and PMI are not encouraging – both of which tanked to historic-low levels in April – is a tell-tale sign that BI has downshifted its growth outlook. Needless to say, if growth alone is the consideration, a rate cut would have made perfect sense. (From our end, we reckon that growth will be at around 1% for the whole of 2020).

Could it have been the worry of global market volatility then that stayed BI's hands today then? Not quite. Perhaps they follow our Market Stress Index too, since the statement actually speaks about the decline in global market uncertainties. In his live-streamed comment, the governor said as much by pointing out the further normalization in a number of volatility measures, including VIX. Again, if the global market has been volatile of late, it would have made sense for BI to hold rate now – but that is not the case.

So, we have a situation where the Rupiah has strengthened – and largely stayed – beyond the level that the central bank said it would hit by year-end much earlier than expected. And we have a growth outlook that has weakened massively in Q1, even before the worst of the impact from the outbreak thus far – and likely to weaken further still. On top of that, we have a relative lack of overt global market volatility which would normally make EM central banks of countries dependent on foreign funding like Indonesia think twice about cutting rate. Add to that the lack of inflationary pressure – and the decision was to hold rate unchanged? Why?

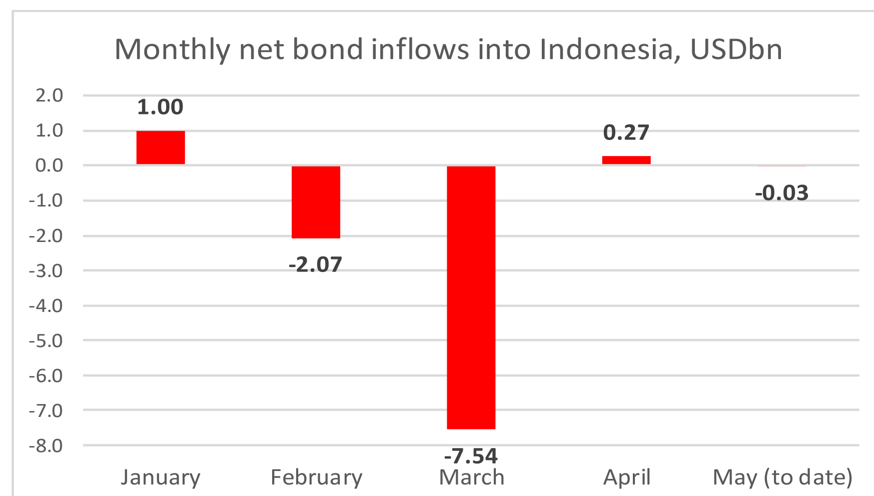
Perhaps BI has a more dire view of the longevity of current global market calm. As mentioned in our report yesterday, anything from the resurgence of virus to US-China rocky relationship can push the market stress level back up again. If that happens, the relative strength that Rupiah has enjoyed thus far would obviously come into question. On this front, however, BI was rather mum.

That leaves us wondering whether the decision to hold rate unchanged might have been related to the upward revision in fiscal deficit yesterday, from the already-high 5.07% to 6.27% of GDP. The revised budget shortfall now is slated to exceed 1 quadrillion Rupiah, compared to around IDR850tn before, signalling a sizably greater amount of extra bond issuance to plug the hole.

While measures such as shepherding the banks to bid for more government bonds via the RRR-cut-MLB-hike move and the allowance for the central bank to step in to buy up to 25% of issuances in the primary auctions offer some cushion for the extra supply, whetting foreign buyers' appetite remains crucial.

Source: OCBC, Bloomberg.

Compared to around 39% of total bond outstanding before the covid-19 mess, foreign ownership has steadily declined to just above 30% recently. While the worst of bond fund outflows may be behind us now, Indonesia has yet to see any sustained resurgence in inflows thus far. Indeed, by our tally of Bloomberg data, up to 18 May, the month-to-date net amount is (very slightly) in the red. It is still a long way from making up the USD7.5bn outflow in March, much less the USD8.4bn year-to-date, and not to mention the additional gap from the wider budget deficit.



Source: OCBC, Bloomberg.

Hence, in a bid to help the government in plugging the fiscal gap, not only has BI been busy sharing the burden of financing it directly now, it must also take into account any impact that its policy rate reduction might have on the real yield calculation that global investors have in mind.

Not an easy job, at all, to say the least. And, as highlighted by the hold decision today, BI is ready ignore a window of opportunity presented by stable Rupiah (that would have allowed it to cut rate) if the need to help their fiscal counterparts appears to be more pressing.

Hence, even though we still expect the policy rate to be lower from here, with 4.0% as a 'terminal rate' by year-end, the timing will remain a tough one to pin down. Not only do we need a stable Rupiah, we also need to see a concomitant uptick in foreign bond fund inflows. We hope to be wrong, but given the recent relatively lacklustre amount in the latter print, it looks like rate cut might be months away still.

Treasury Research & Strategy

Macro Research

Selena Ling
Head of Research & Strategy
LingSSSelena@ocbc.com

Tommy Xie Dongming
Head of Greater China Research
XieD@ocbc.com

Wellian Wiranto
Malaysia & Indonesia
WellianWiranto@ocbc.com

Terence Wu
FX Strategist
TerenceWu@ocbc.com

Howie Lee
Thailand, Korea & Commodities
HowieLee@ocbc.com

Carie Li
Hong Kong & Macau
carierli@ocbcwh.com

Dick Yu
Hong Kong & Macau
dicksnyu@ocbcwh.com

Credit Research

Andrew Wong
Credit Research Analyst
WongVKAM@ocbc.com

Ezien Hoo
Credit Research Analyst
EzienHoo@ocbc.com

Wong Hong Wei
Credit Research Analyst
WongHongWei@ocbc.com

Seow Zhi Qi
Credit Research Analyst
ZhiQiSeow@ocbc.com

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