Indonesia

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Use It or Lose It

Why Bank Indonesia is cutting rate this week

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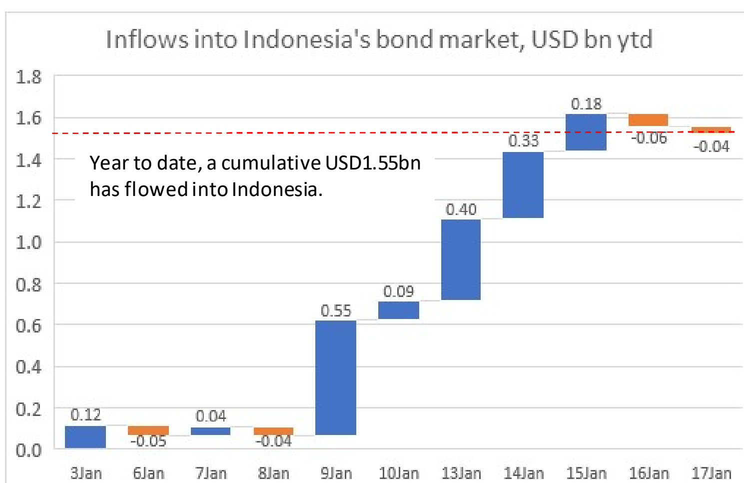
- Bank Indonesia is holding its maiden MPC for 2020 this week, and we expect it to open the year with a decisive and confident interest rate cut of 25bps, bringing its policy rate to 4.75%.
- If all that BI cares about are domestic factors, the cut would be a no-brainer. After all, it has the space given by inflation that is well within target range. And, it has the need to do so given still-lackluster loans growth.
- However, Indonesia is no autarky and BI's bound by global factors with an eye on currency stability. Courtesy of friendly global environment recently, a window of opportunity has opened for BI to do what it needs to do.

Slotting one in

It is obviously way too soon to write a retrospective of 2020. Nonetheless, it is worth noting how the year had opened with quite a bit of fanfare. Globally, markets were jolted from any New Year's hangover by the escalation of US-Iranian tensions. In Indonesia, flooding of the capital city doused any festive mood rather quickly, and indeed would have left many to wonder if it portended an especially challenging year ahead for the country.

Thankfully, things have started to turn friendlier in recent days, with the Middle East tensions seemingly old news by now. Combined with a conclusion of the US-China Phase 1 deal, and that is all that the market needs, it seems, to don a risk-on mantle.

It is telling for instance, that the fund inflows have surged into Indonesia of late. Year-to-date, the government bond market alone saw an inflow of USD1.55bn, which pushed the foreign ownership level to 39.2% of overall outstanding sovereign bonds. The strength of the inflows has translated to a sharp rally in the Indonesian Rupiah, with the USDIDR level breaking decisively below 13700 level.

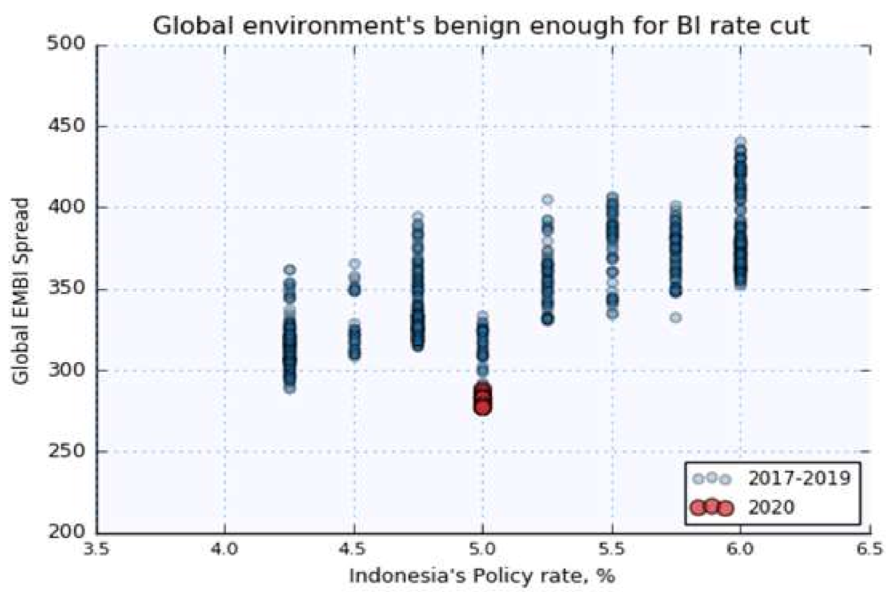


Source: OCBC, Bloomberg.

The sizable move has been aided by Bank Indonesia's suggestion that it is refraining from intervention, since it views the appreciation to be in line with market fundamentals. While President Jokowi's murmurs about how export competitiveness might be hurt if Rupiah appreciates too quickly has slowed the pace of gains, the Rupiah has nonetheless stayed at the strong level since.

To us, the fact that BI has given its nod to Rupiah's appreciation is a sign that it may be adding to the space needed for a rate cut this week. It helps too that foreign exchange reserves have been building up to a comfortable level of USD129.2bn, the highest in two years. The reassurance provided by the healthy foreign reserves numbers has removed the immediate need for BI to intervene massively by socking away the inflows into its pot.

From a broader perspective, one measure that we look at in gauging whether global risk sentiment is friendly enough for BI to countenance a rate cut is the global EMBI spread, an indication of market's comfort level with emerging markets overall. Indeed, by our calculation, since 2017, the correlation between BI rate and the global EMBI spread has been a tight 0.8. Given that EMBI spread has declined significantly to below 300 points since the start of 2020, it suggests that BI rate can be lower than the current level as well.



Source: OCBC, CEIC, Bloomberg.

Given that there is no way of knowing how long the global risk-on sentiment would last, our sense is that BI would be keen to use the window of opportunity to trim the policy rate further.

After all, domestic stars are aligned too, with inflation at 2.72% as of Dec 2019. Even as Jakarta's flood and overall unfavorable weather across other parts of the country may contribute to higher food inflation, it is unlikely to be enough for BI and markets to worry about unceasing inflation uptick, partly because of the buffer offered by the recent low inflation prints.

Outside of domestic space, there is also the domestic need to cut rate a bit more. While BI has cut rate by 100bps already last year, the apparent lack of pass-through, in terms of increase in loans growth and reduction to lending rates have been a bugbear for the policymakers. BI may thus feel compelled to trim rate further and soon to boost growth – hoping that the next rate cut will be the last straw that break the slow-transmission camel's back.

Source: OCBC, CEIC, Bloomberg.

While other potential policy support in the form of fiscal and structural reforms are there, they are relatively limited as well. On the fiscal front, while there are talks about potential revision to the cap of 3% of deficit over GDP to allow the government to spend more, it is unlikely to be enacted anytime soon and rightly so, given its potential repercussions on Indonesia's hard-won fiscal credibility.

On structural reforms, while we remain hopeful that President Jokowi's push for investment and taxation omnibus bills through the parliament may see eventual success, the path ahead remains an uncertain one and likely to be riddled with delays. (Labor reform in particular remains an especially tricky one, with unions already planning huge protests – a risk that we noted in our 12 Nov 2019 report, "Give Them a Break", which could be potentially counterbalanced with giving the workers more leave days)

Hence, BI's monetary policy support may remain the main game in town, unfortunately. However, ultimately, BI is well aware that there is only so much it can do in cutting rates to boost growth – we see rate settling at 4.5%, i.e. just one more rate cut beyond this week. In part because of this, it knows that utilizing the precious space early would make more sense than later, if the global environment allows for it. To us, this week presents BI with just such a moment. It ought to use it.

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