Welcome back my friends to the war that never ends

22 April 2024

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Summary

- Over the past week, the Rupiah fell while capital flowed out of Indonesian assets, with some of the decline plausibly driven by "flight to safety" amid an escalation of the Middle Eastern conflict.
- However, even without further escalation, there are good reasons for the USD and oil prices to remain elevated in the near-term, given the run of solid US macro data and an ongoing net inventory drawdown in the global oil market.
- Since USD and oil are now positively correlated, the government may incur large fiscal costs to maintain current fuel prices, although the present USD/oil levels do not yet warrant immediate price hikes.
- The situation could have substantial silver linings for Indonesia, in the form of potentially higher commodity prices and a rebound in GDP deflator, which could finally curtail the "inverse money illusion" of recent quarters.

Rude awakening from the holiday slumber

- On Sunday, April 14th, Indonesians awoke to the news that Iran was launching large-scale aerial attacks on Israel. The following Tuesday – the first time the markets opened after the Lebaran holidays – they experienced a different kind of shock. Within minutes, the Rupiah plunged past the "round-number benchmark" of 16,000, previously seen as sacrosanct. Equities and bonds likewise saw red during the day and throughout the week.

- By weekend, the "casualty list" read as follows: Rupiah down to 16,255/USD (-2.5%), the JCI closed at 7,087.3 (-2.7%), and the yield on the government's 10Y IDR bonds surged to 6.98% (+33 bps). Foreign capital led the stampede, rushing out to the tune of IDR 21.46 Tn (USD 1.32 Bn) according to BI's estimates. Even the relatively safe, short-term SRBIs were not spared from these outflows.

- If you think that we are making things sound a bit dramatic – well, yes we are, quite deliberately. Indonesians have a historical jitteriness when it comes to the exchange rate, and the media is awash with breathless pronouncements about Rupiah being at its WEAKEST EVER since 1998 or the COVID-19 pandemic. And the fact that this shock followed the escalation in the Middle East makes things inextricably interlinked in many people's minds.

- In this edition, then, we need to set things straight. We will show that firstly, the Rupiah's weakness is only partly related to the Israel-Iran crisis, which means that things may not greatly improve even if the conflict is to simmer down – or, more likely, settle into a kind of "phony war". Secondly, we would argue that a weaker Rupiah (and higher oil price) will force the government to reassess some of its more ambitious targets – but this situation is not without its silver linings for Indonesia.

Double whammy

- Well before Israel's initial attack on an Iranian consulate in Syria (April 1st), the US Dollar was already on an upward march, buoyed by a shift in rate expectations. Whereas the market expected six FFR cuts at the turn of the year – which we have always seen as implausible – the room to cut largely evaporated in Feb-Mar, as US macro data continued to beat expectations ***(see Chart 1, left).***
- Such strength spells trouble for the Fed's effort to bring inflation back down to 2% YoY, especially with core inflation now on the rise again. This is complicated by the increase in oil prices, which – similarly to the USD's rise – preceded the Israel-Iran crisis. Rising energy prices pushes up inflation expectations, which in turn cause FFR futures and the USD to rise.

Positive correlation between oil and USD is a double blow to oil-importing countries like Indonesia

- Note, however, that the close, positive correlation between oil and USD is quite a new phenomenon ***(see Chart 1, right).*** Prior to 2021-22, it was more common for oil and USD to move in opposite directions, which makes sense: a weaker USD translates to stronger global liquidity and global growth, which drives up demand for oil and other commodities.
- It is a sign of how credible the Fed's inflation-targeting signaling has been over the past two years, that the two are now moving pretty much in tandem***.*** Unfortunately, as we will see, this presents a double blow for an oil-importing country like Indonesia, especially if – as we argue – the increase in oil price has little to do with short-term geopolitical flux, but much more with supply-and-demand fundamentals.
- Since Q4-23, global oil inventories have stopped rising, and is now in the midst of an inventory drawdown ***(see Chart 2).*** This drawdown is not as extreme as in 2021, but given possible (non-war) supply-side constraints – output cut by OPEC+, rising fiscal breakeven price for Saudi Arabia – it is probably sufficient to raise the Brent crude price towards the USD 85 – 95 range per barrel.
- For a while, this inventory decline was masked by optimism over US shale output and pessimism about Chinese demand, keeping prices in the low 80s. The Israel-Iran crisis, then, may simply be a "fog buster" that clears out these erstwhile narratives and accelerates convergence towards a new (and higher) fundamental price level.
- Our argument, then, is that further escalation between Israel and Iran is not strictly necessary

for the USD and oil price to remain near (or slightly above) current levels. And indeed, further escalation is probably not on the cards – if anything, Iran's strike (and Israel's counterstrike on April 19th) can be seen as an attempt of "escalating to de-escalate". Both countries' leaders have struck a sufficiently tough posture and can claim a "win" for their respective domestic audience, without making significant damage that would necessitate a bigger reprisal.

- As of now, the broader picture in the Middle East remains one of continuous conflict with hefty humanitarian and diplomatic import, but relatively manageable impact on the global economy. Iran's preferred tactic, i.e. proxy war through various militias like the Houthis, made a splash due to attacks on Red Sea shipping, but their impact has been waning of late as shipping costs normalize (although the volume of traffic through the Suez Canal has not).

Costs and benefits

- The fact that USD is likely to move in parallel with oil is of particular challenge to the government, which usually cushions the fluctuations in energy prices through direct or indirect subsidies (the so-called "compensations"). Often, for political considerations, the government holds off hiking fuel prices and expand energy subsidies instead – until the cost eventually proves untenable. The most recent such episode was in 2022, when the government only hiked the price of basic gasoline (Pertalite) and diesel fuel (Biosolar) in September, a full six months after the Ukraine War started.
- The cost is even bigger given the government's relatively sanguine budget assumptions for 2024 ***(see Chart 4),*** versus even our moderate baseline case earlier in the year. Even at current market prices, the government is on track to widen its deficit by about Rp 50 Trillion (0.22% of GDP). This is still a distance away from the fiscal cap – 3% of GDP, which would require e.g. Brent at USD 110/barrel and USD/IDR at 16,800 – but it could force the government to reduce non-essential spending to preserve some fiscal buffer.
- More importantly, this situation presents a dilemma for incoming president Prabowo Subianto, who aims to provide free meals for children, among other campaign promises. There are several options to finance this program, e.g. starting with a smaller-scale pilot, reallocating budget from elsewhere, or amending the law that caps the fiscal deficit.
- If oil and USD continues to rise, however, Prabowo could soon find himself in a situation familiar to the past two presidents. Both SBY and Jokowi begun their presidencies facing large current account deficits and misaligned fuel prices (relative to global), which they soon had to rectify. Within five months of the start of their terms, both presidents had to hike retail fuel prices – spending much of their political capital in the process.
- Despite this threat, the situation may have some benefits for Indonesia. Oil price rarely rises alone, and they are usually a harbinger of a more broad-based boom in commodities, as we saw in 2021-22. Keep in mind, however, that the correlations between oil and other commodities are imperfect, and the situation might turn out more like 2012-13, where

Indonesia's terms of trade suffered due to high oil prices ***(see Chart 3).***

Keeping Rupiah elevated while other commodities rise along with oil might be a recipe for a Dutch disease

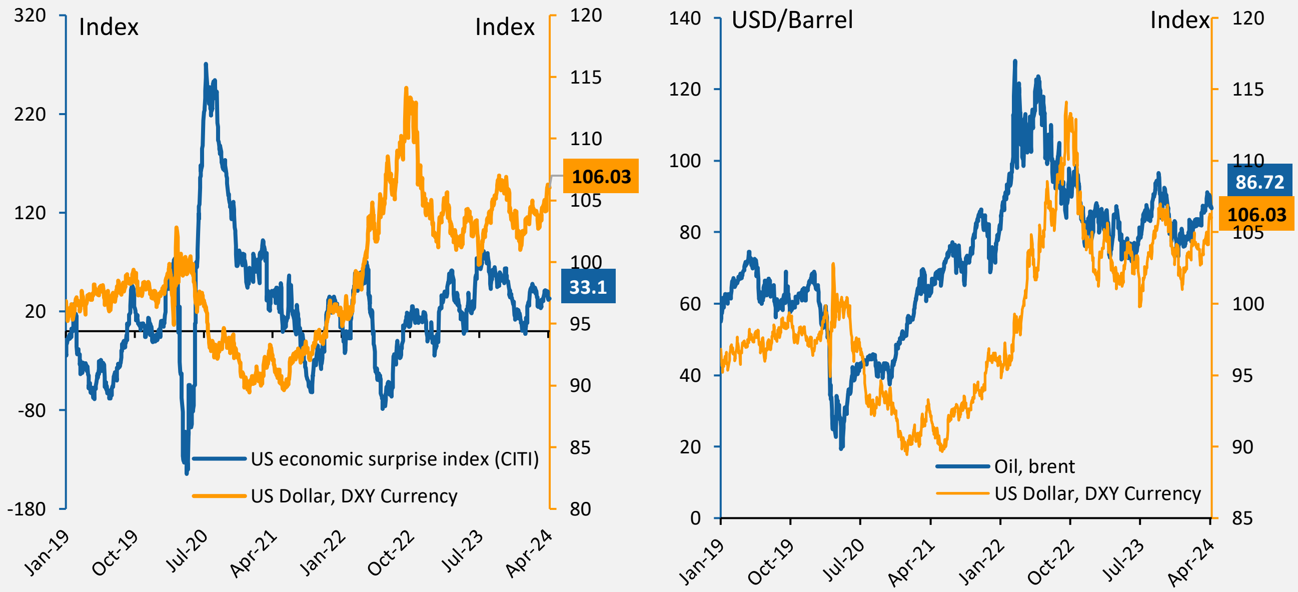
- Meanwhile, a weaker Rupiah could be a boon for exporters – or, more precisely, reluctance to let the Rupiah depreciate could harm Indonesian exporters. The USD's recent strength is broad-based, and most of Indonesia's main trading partners are seeing depreciation at similar scales ***(see Chart 5).*** Furthermore, some countries – most notably China – is pursuing an aggressive export-led strategy. Keeping Rupiah elevated while other commodities rise along with oil is, most likely, a recipe for a Dutch disease in the longer-run.

- Finally, the global inflation that would accompany the USD/oil rally may bolster Indonesia's GDP deflator, which had been running negative in Q4-23 and caused nominal GDP growth to run below that of real GDP. As we wrote before, this seems to lead to an "inverse money illusion", where less income begets less spending. It may take this renewed pressure to finally break the malaise that had plagued the Indonesian economy since mid-2023 and lead to renewed vigor – after a rather costly adjustment initially.

Chart 1

Old friend, new friend

Overperforming US macro data has always been a harbinger of stronger USD, but the close correlation between oil and USD is a newer phenomenon



Source: Bloomberg. Calculations by BCA Macroeconomic Research

Chart 2

The tables turning quietly

Oil demand has narrowly surpassed oil production in recent quarters, turning the net inventory addition of 2022-23 (led by US SPR) into a slight drawdown

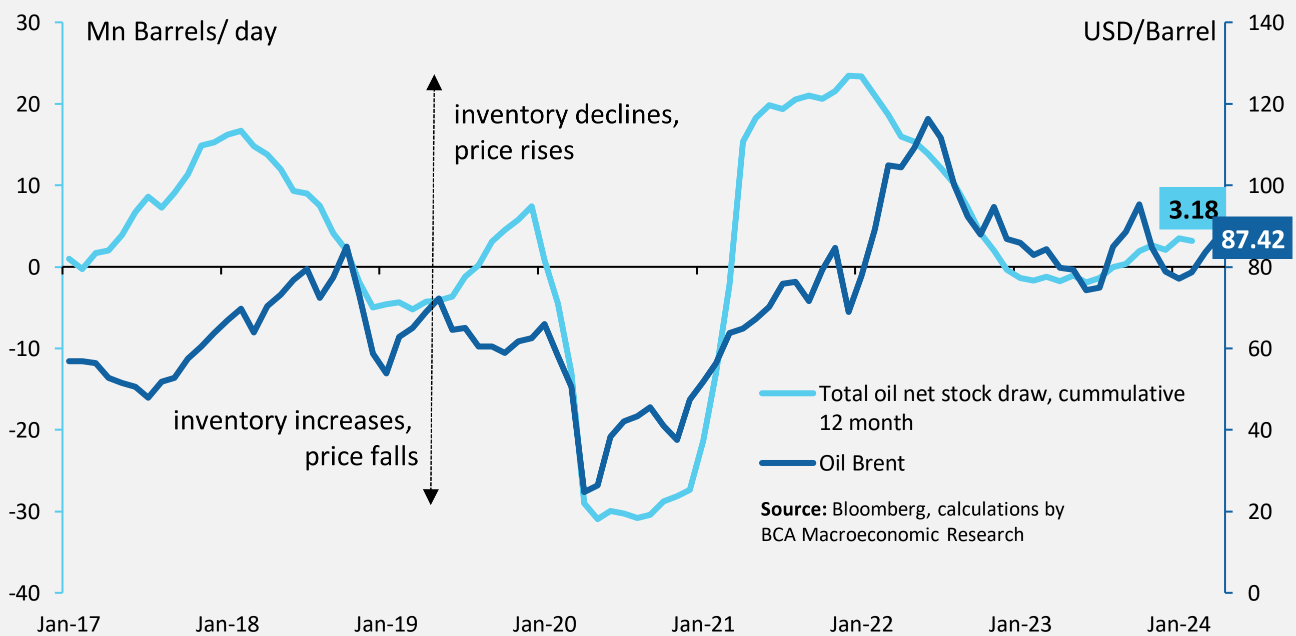
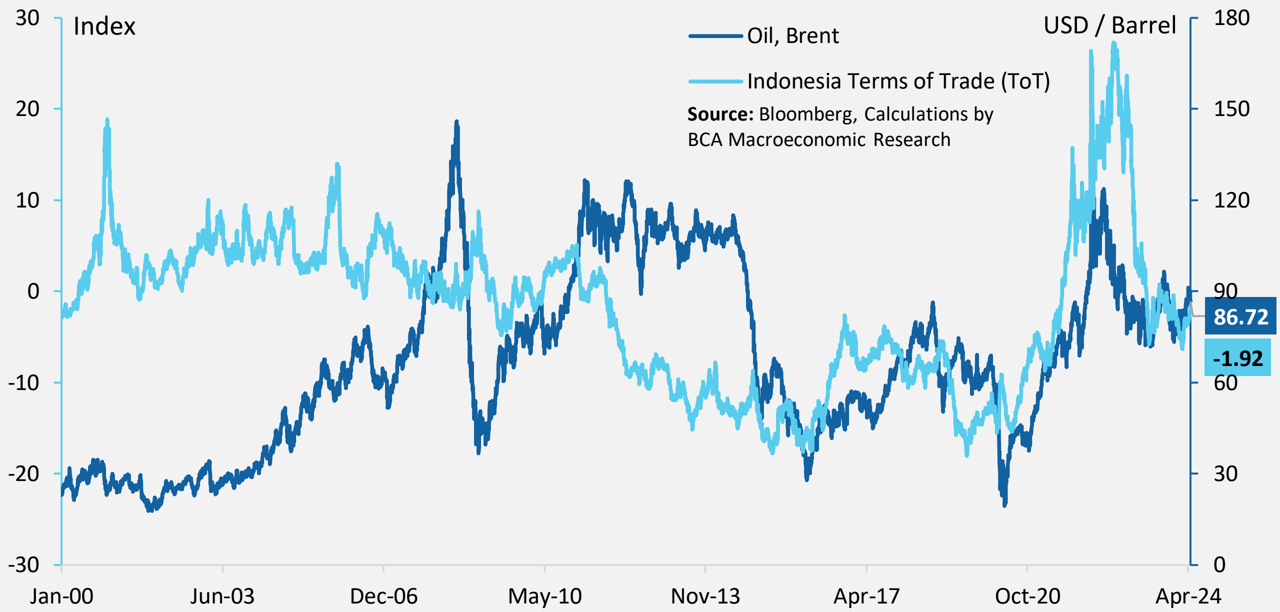


Chart 3

Occasionally beneficial

While Indonesia is a net oil importer, an increase in oil price often tends to lift other commodities too, such that our terms of trade occasionally benefits (but occasionally not)

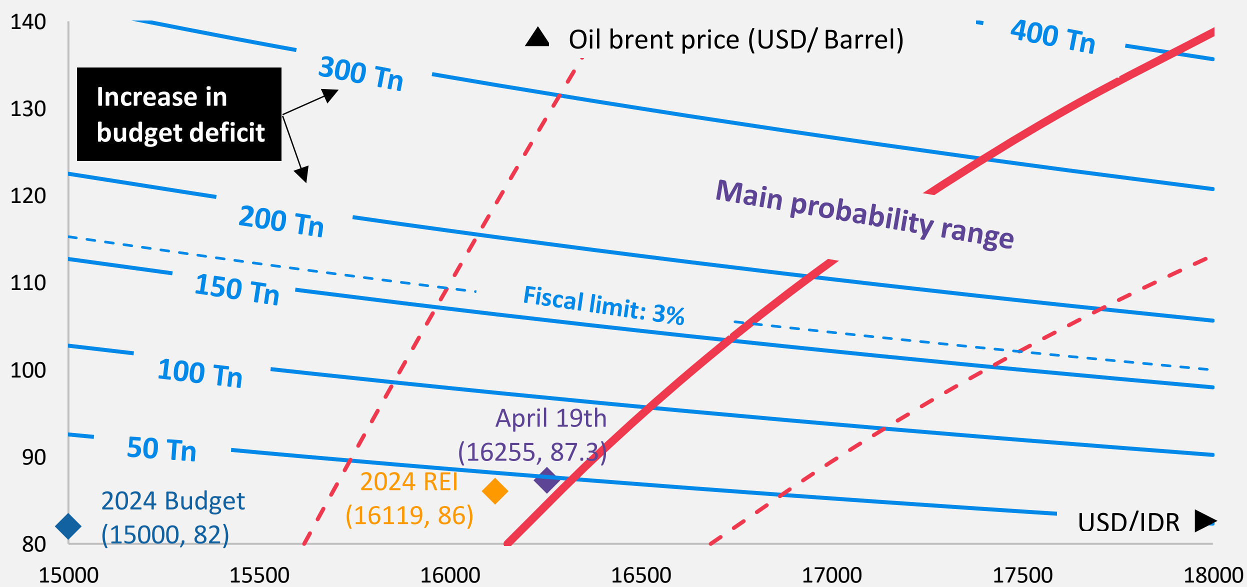


Source: Bloomberg, Calculations by BCA Macroeconomic Research

Chart 4

Big burden to shoulder

At current oil prices and USD/IDR levels, the fiscal deficit is likely to be wider by IDR 50 Tn (0.22% of GDP), driven by energy subsidies (although slightly offset by higher revenues)

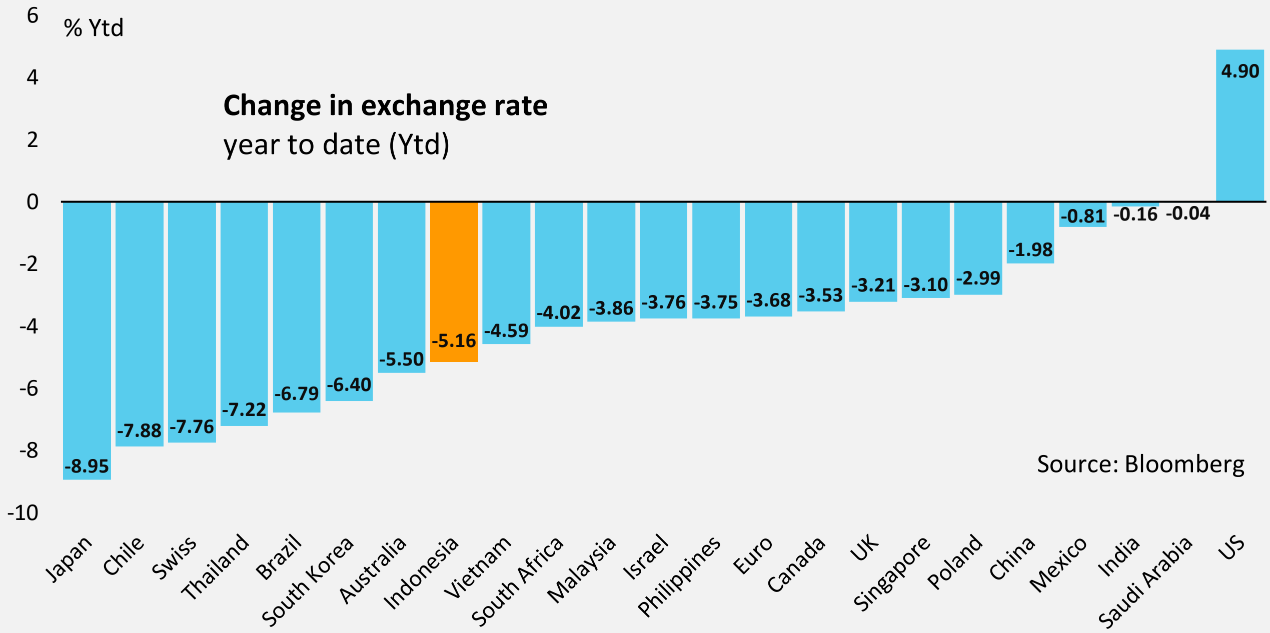


Source: Bloomberg, Pertamina, Indonesia Ministry of Finance
Modeling by BCA Macroeconomic Research

Chart 5

You are not alone

Most currencies have been slumping against the USD so far this year, and an attempt to maintain a comparatively stronger Rupiah may weaken Indonesia's non-commodity exports



Source: Bloomberg

Economic Calendar

		Actual	Previous	Forecast*
1 April 2024				
ID	**Inflation rate YoY**, %	**3.05**	**2.75**	**2.9**
ID	S&P Global Manufacturing PMI	54.2	52.7	52.6
CN	Caixin Manufacturing PMI	51.1	50.9	51.0
US	ISM Manufacturing PMI	50.3	47.8	48.3
2 April 2024				
US	JOLTs Job Openings (Mn)	8.76	8.86	8.84
EU	Inflation rate YoY, %	2.4	2.6	2.6
4 April 2024				
US	Balance of Trade (USD Bn)	-68.9	-67.4	-68.0
5 April 2024				
ID	**Foreign Exchange Reserves (USD Bn)**	**140.4**	**144.0**	**143.0**
US	Non-Farm Payroll, (Th)	303	270	200
US	Unemployment Rate, %	3.8	3.9	3.9
7 April 2024				
ID	Motorbike Sales YoY, %	-7.8	-2.9	-
8 - 15 April 2024				
ID	Eid Al-Fitr Holiday			
10 April 2024				
US	Inflation rate YoY, %	3.5	3.2	3.4
11 April 2024				
CN	Inflation rate YoY, %	0.1	0.7	1.2
ID	Car Sales YoY, %	-26.2	-18.8	-
12 April 2024				
CN	Balance of Trade (USD Bn)	58.5	125.1	64.0
16 April 2024				
ID	Consumer Confidence	128.8	123.1	123.4
17 April 2024				
ID	Retail Sales YoY, %	6.4	1.1	1.2
22 April 2024				
ID	**Balance of Trade (USD Bn)**	**4.47**	**0.87**	**1.5**
24 April 2024				
ID	**BI Rate Announcement**, %		**6.0**	**6.0**
ID	Loan Growth YoY, %		11.28	-
29 April 2024				
ID	**Foreign Direct Investment YoY**, %		**5.3**	**-**

*Forecasts of some indicators are simply based on market consensus
Bold indicates indicators covered by the BCA Monthly Economic Briefing report

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	5.50	Dec-23	2.30
UK	5.25	Dec-23	1.85
EU	4.50	Dec-23	1.90
Japan	-0.10	Jan-16	-2.90
China (lending)	2.50	Dec-23	3.65
Korea	3.50	Nov-23	0.40
India	6.50	Dec-23	1.41
Indonesia	6.00	Nov-23	2.95

Money Mkt Rates	28-Mar	-1 mth	Chg (bps)
SPN (1M)	5.88	5.80	7.6
SUN (10Y)	6.69	6.56	12.9
INDONIA (O/N, Rp)	5.91	5.96	-5.2
JIBOR 1M (Rp)	6.65	6.64	0.8

Bank Rates (Rp)	Dec	Nov	Chg (bps)
Lending (WC)	8.86	8.91	-4.93
Deposit 1M	4.76	4.52	24.61
Savings	0.69	0.67	1.94

Currency/USD	28-Mar	-1 mth	Chg (%)
UK Pound	0.792	0.788	-0.48
Euro	0.927	0.922	-0.57
Japanese Yen	151.4	150.7	-0.45
Chinese RMB	7.227	7.198	-0.40
Indonesia Rupiah	15,855	15,630	-1.42

Capital Mkt	28-Mar	-1 mth	Chg (%)
JCI	7,288.8	7,283.8	0.07
DJIA	39,807.4	39,069.2	1.89
FTSE	7,952.6	7,684.3	3.49
Nikkei 225	40,168.1	39,233.7	2.38
Hang Seng	16,541.4	16,634.7	-0.56

Foreign portfolio ownership (Rp Tn)	Feb	Jan	Chg (Rp Tn)
Stock	3,236.2	3,115.8	120.46
Govt. Bond	837.1	841.9	-4.76
Corp. Bond	9.5	10.4	-0.89

Trade & Commodities	28-Mar	-1 mth	Chg (%)
Baltic Dry Index	1,821.0	1,871.0	-2.7
S&P GSCI Index	582.5	555.9	4.8
Oil (Brent, $/brl)	87.5	82.5	6.0
Coal ($/MT)	132.0	128.5	2.7
Gas ($/MMBtu)	1.54	1.65	-6.7
Gold ($/oz.)	2,229.9	2,031.2	9.8
Copper ($/MT)	8,766.5	8,361.5	4.8
Nickel ($/MT)	16,568.0	16,930.8	-2.1
CPO ($/MT)	905.2	834.2	8.5
Rubber ($/kg)	1.60	1.58	1.3

External Sector	Feb	Jan	Chg (%)
Export ($ bn)	19.31	20.49	-5.79
Import ($ bn)	18.44	18.49	-0.29
Trade bal. ($ bn)	0.87	2.00	-56.64
Central bank reserves ($ bn)*	144.0	145.1	-0.72

Prompt Indicators	Feb	Jan	Nov
Consumer confidence index (CCI)	123.1	125.0	123.6
Car sales (%YoY)	-18.8	-26.1	-7.5
Motorcycle sales (%YoY)	-2.9	-3.7	-2.8

Manufacturing PMI	Feb	Jan	Chg (bps)
USA	52.2	50.7	150
Eurozone	46.5	46.6	-10
Japan	47.2	48.0	-80
China	50.9	50.8	10
Korea	50.7	51.2	-50
Indonesia	52.7	52.9	-20

Source: Bloomberg, BI, BPS
Notes:
*Data from an earlier period
For changes in currency: **Black indicates appreciation against USD, **Red** otherwise
***For PMI, **>50** indicates economic expansion, **<50** otherwise

Indonesia – Economic Indicators Projection

	2019	2020	2021	2022	2023	2024E
Gross Domestic Product (% YoY)	5.0	-2.1	3.7	5.3	5.0	5.0
GDP per Capita (US$)	4175	3912	4350	4784	4920	5149
Consumer Price Index Inflation (% YoY)	2.7	1.7	1.9	5.5	2.6	3.2
BI 7-day Repo Rate (%)	5.00	3.75	3.50	5.50	6.00	6.00
USD/IDR Exchange Rate (end of the year)*	13,866	14,050	14,262	15,568	15,397	16.119
Trade Balance (US$ billion)	-3.2	21.7	35.3	54.5	37.0	32.6
Current Account Balance (% GDP)	-2.7	-0.4	0.3	1.0	-0.1	-0.5

* Estimation of the Rupiah's fundamental exchange rate

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