FOMC:
A rate and balance sheet tug-of-war

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Executive Summary

- The Fed maintained its policy rate at 5.25-5.50% range, signalling that the FFR may not come any sooner, given the returning inflationary pressure and the now-longer monetary policy transmission in the US.
- The Fed's decision to delay its rate cut campaign may widen the monetary policy differential between the Fed and other central banks, as weaker growth momentum elsewhere may encourage other central banks to go ahead with their rate cut plan.
- The tapered UST run-off may help other bond markets maintain their rate differentials, lowering the risk of uncontrolled capital outflows that may arise in the event of spiking UST yields.

- The US macroeconomic landscape has not developed as the Federal Open Market Committee (FOMC) had expected for 2024. The "last mile" of the inflation fight has been extended by another mile, while the tight US labour market also continues to fan the concern over wage-price spiral risks. Against this backdrop, the Fed has decided to maintain the Federal Funds Rate (FFR) at the 5.25-5.50% range, in line with the most recent development in the market's increasingly mercurial policy rate expectation.

- The policy decision may not be surprising, but notable changes in the post-meeting statement still make the recent meeting a momentous one for the market. While Fed Chair Jerome Powell has cooled down the possibility of a rate hike as the Fed's next move, **the 75 bps rate cuts scenario telegraphed in the March 2024 summary of economic projections does not seem to reflect FOMC members' line of thinking anymore.**

- Alas, there is a growing scepticism that the Fed's higher-for-longer (HFL) policy guidance could finally quell the re-emerging inflationary pressure once and for all. A recent study suggests that **American households have been less impacted by changes in the policy rate**, thanks to mortgage refinancing during the pandemic years. The increasingly service-driven nature of US business further disincentivises the US real sector to take a good look at the interest rate situation (the service sector is generally less capital-intensive than the manufacturing sector), further prolonging the monetary policy lag. **We may not see the FFR moving to a higher peak, but the policy rate may remain elevated for even longer periods.**

- The US economy's relatively robust condition (despite its lower-than-expected 1.6% QoQ GDP growth in Q1 2024) may enable the Fed to double down on its HFL outlook. However, other global central banks are finding themselves in different waters. Indeed, central banks in Europe and Asia are operating in a much weaker growth environment, making the case for a looser rate environment more compelling outside the US economy. **The policy divergence between the Fed and other major central banks may continue to widen**, thereby setting the stage for a stronger USD in the upcoming periods ***(see Chart 1)***.

- Nowhere is a strengthening USD more unpalatable than in the boardroom of Asian central bankers, given the complexities that a stronger USD poses to inflation dynamics in the Asian economy. The Bank of Japan is understood to have spent around USD 35 Bn to defend the JPY last Monday alone, which may have succeeded in yanking the JPY back below the 160/USD threshold but is yet to chase speculators away from the Asian FX market.

- **Constant barrages on the JPY due to the strengthening of the USD may have a broad impact on the market for other Asian currencies.** The CNY, for instance, has been moving in tandem with the JPY since 2022 – in some part due to industrial competition between the two Asia's manufacturing powerhouses that bind the two currencies to a competitive devaluation. Meanwhile, continuous FX interventions by the BoJ may also force the central bank to sell some of its foreign assets, a strategy that we fear could exacerbate the foreign sell-off problem in financial markets across Asia and globally, given Japanese investors' significant role in the global financial market.

"Investors' worsening sentiment for major Asian currencies may amplify the negative impact of the Fed's extended higher-for-longer policy signal on the Asian market".

- It is safe to say, then, that the intensifying pressure that may stem from the Fed's "prolonged HFL" outlook is mostly bad news for the global financial market (outside of the US market). Its negative impact on Asian currencies, including the Rupiah, may turn out to be even more significant, given the contagion effect from investors' worsening sentiment on major Asian currencies such as the JPY and the CNY.

- However, **the recent FOMC meeting is not all bad news for the global financial market.** Hidden beneath strong words on inflation and future interest rate trajectory, **the Fed's decision to slow down the pace of its treasury run-off from USD 60 Bn to USD 25 Bn per month may calm the market**, as it answers the market's inquest about what the Fed could do to mitigate the liquidity risk in the UST market.

- In hindsight, given its well-documented CRE losses and underwater bond holdings, the Fed's decision to slow down its QT campaign may look like a response to bail US banks out of their pressing situation. However, a quick look at the liabilities side of the Fed's balance sheet would eliminate this view. Rising bank reserves and the declining RRP balance show that US banks are enjoying an improving liquidity condition ***(see panel 7)***, lowering the risk of an abrupt fire sale event that may further highlight the liquidity concern in the UST market.

- The treasury general account (TGA) has also been rising in recent weeks (reaching USD 929.38 Bn by the end of April 2024), indicating an ample liquidity condition within the US public sector. The Fed, then, is under no urgency to stop its balance sheet from shrinking further, showing that the recently announced QT taper (albeit limited to the UST market) is truly a dovish move.

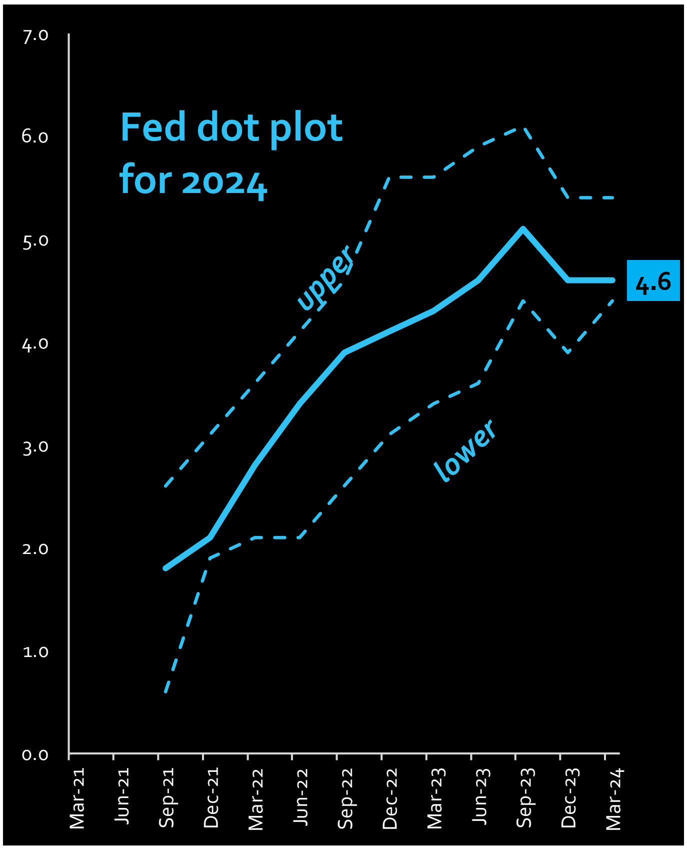
- What explains this dovish move, then? The Fed has been experimenting to separate its interest rate and balance sheet policy for some time, with the balance sheet policy largely targeted towards stabilisation efforts in the US financial market. Such a *modus operandi* is likely to hold. After all, continuous expansions in the US Treasury Department's quarterly borrowing plan (USD 243 Bn in Q2 2024, USD 847 Bn in Q3 2024) will continue to add supply to the UST market – potentially exposing the market to further liquidity risks.

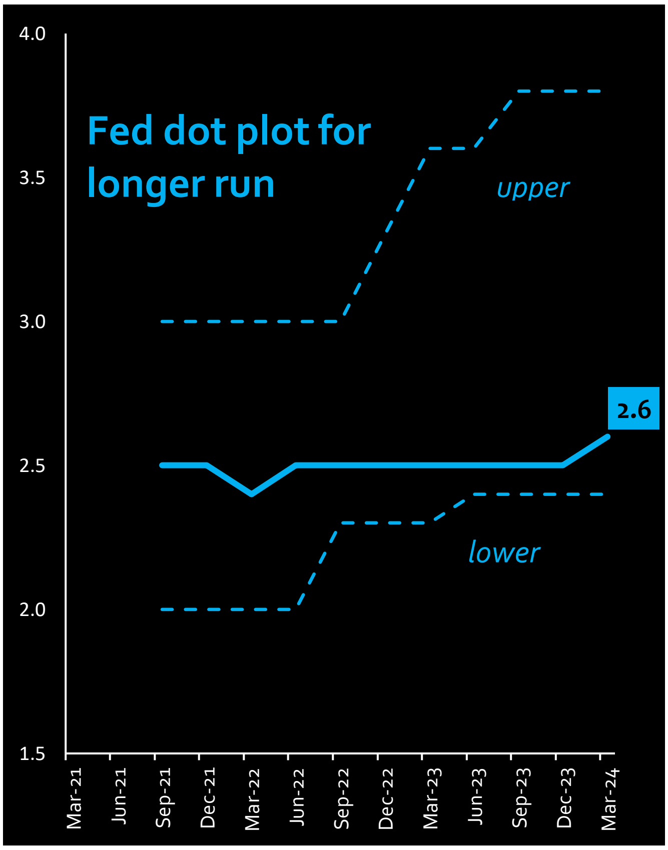
- The tapered UST run-off, coupled with the Treasury buyback programme announced earlier, will help to improve the outlook for the UST market and should lower volatility in the UST market. This outcome may also provide an added benefit for other financial markets, which is especially relevant to the Indonesian case. **The improving liquidity condition in the UST market may calm the sell-off pressure in the SBN market, which often preludes periods of stress in the Rupiah's exchange rate.** Hence, a lower risk of outflows from the SBN market may translate positively to the outlook for the Rupiah, although **challenges remain given the limited room for Bank Indonesia to widen the real policy rate differential** (the difference between the BI Rate and FFR minus inflation) amidst the Fed's prolonged HFL outlook.

- Indeed, the real policy rate differential (the difference between the BI Rate and FFR minus inflation) seems to be more predictive of the USD/IDR exchange rate compared to the long-term rate differential (the difference between 10Y SBN and the 10Y UST yield minus inflation), especially in the post-pandemic years. This means that **the added pressure from the Fed's prolonged HFL scenario may overpower the positive impact of the tapered UST run-off, adding the urgency for Bank Indonesia to strengthen its pro-stability signal** that may even result in another rate hike should external factors continue to test the Rupiah's resilience.

> ***"Lower volatility in the UST and global bond market may ease the pressure on the Rupiah, but challenges remain".***

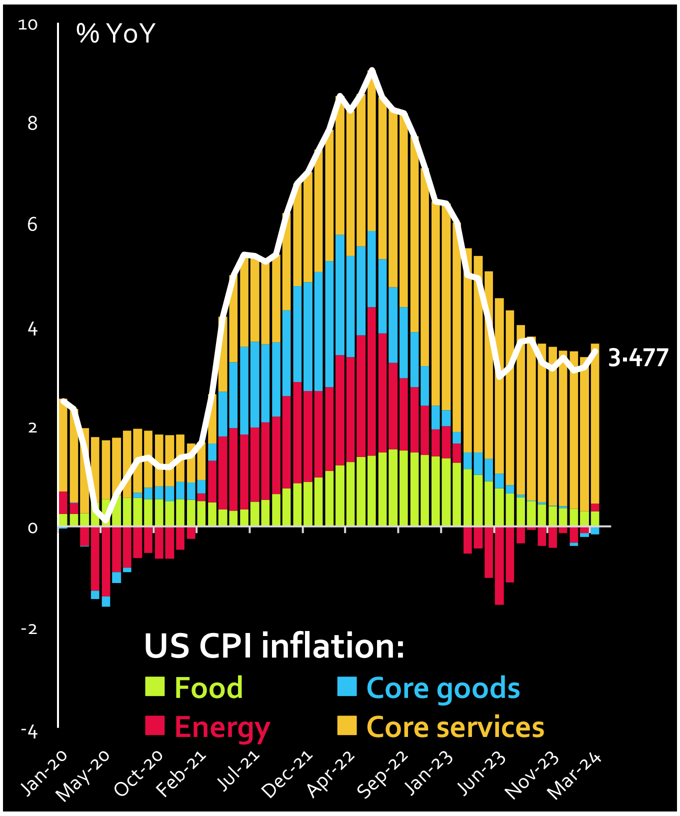
Panel 1. **The Fed may need to maintain a high-rate environment for a prolonged period, given the returning inflationary pressure and the longer monetary policy transmission in the US**

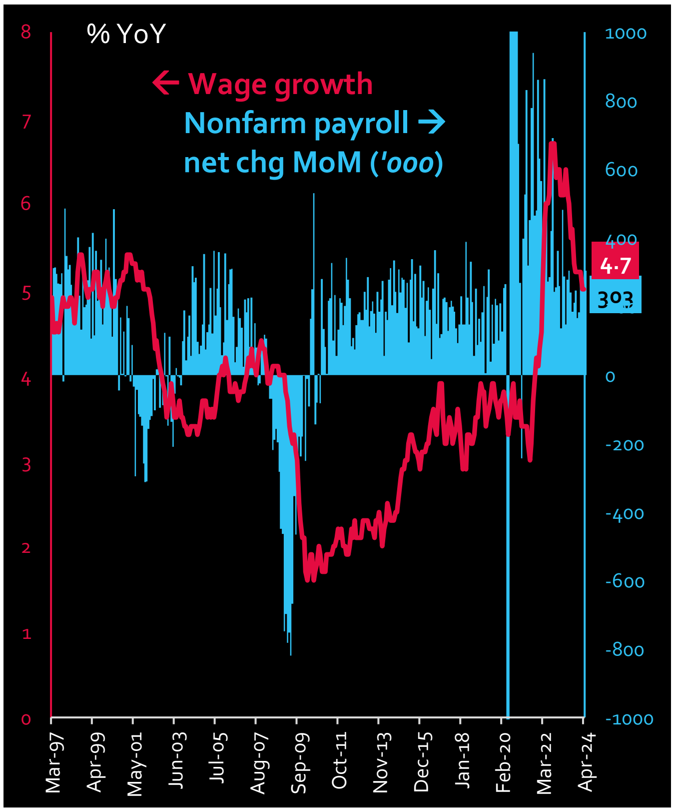




Source: Federal Reserve

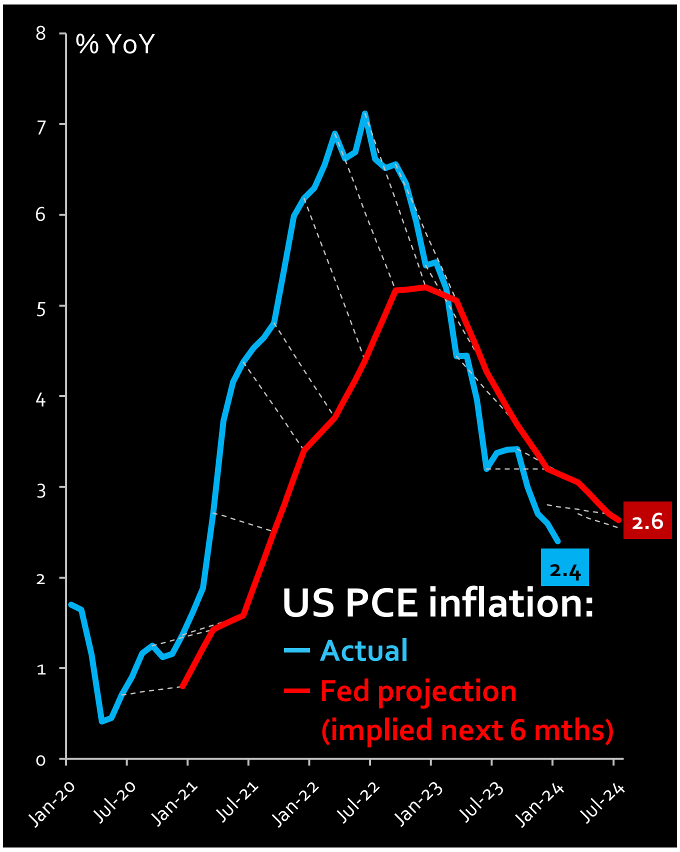
Panel2. Ongoing reflation in the energy and services components may delay disinflation progress even as shelter sector inflation continues to slow

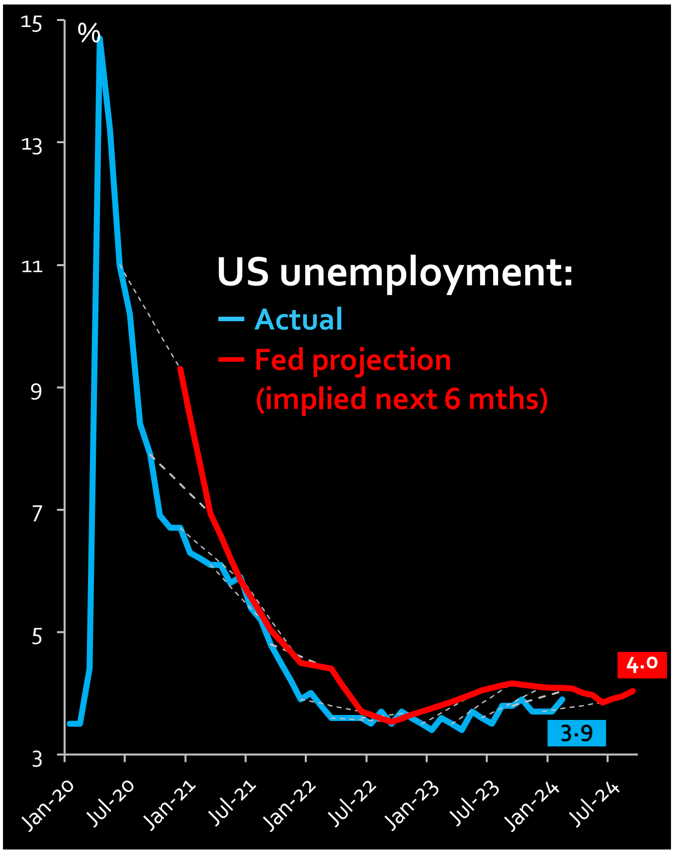




Source: US BLS, Bloomberg

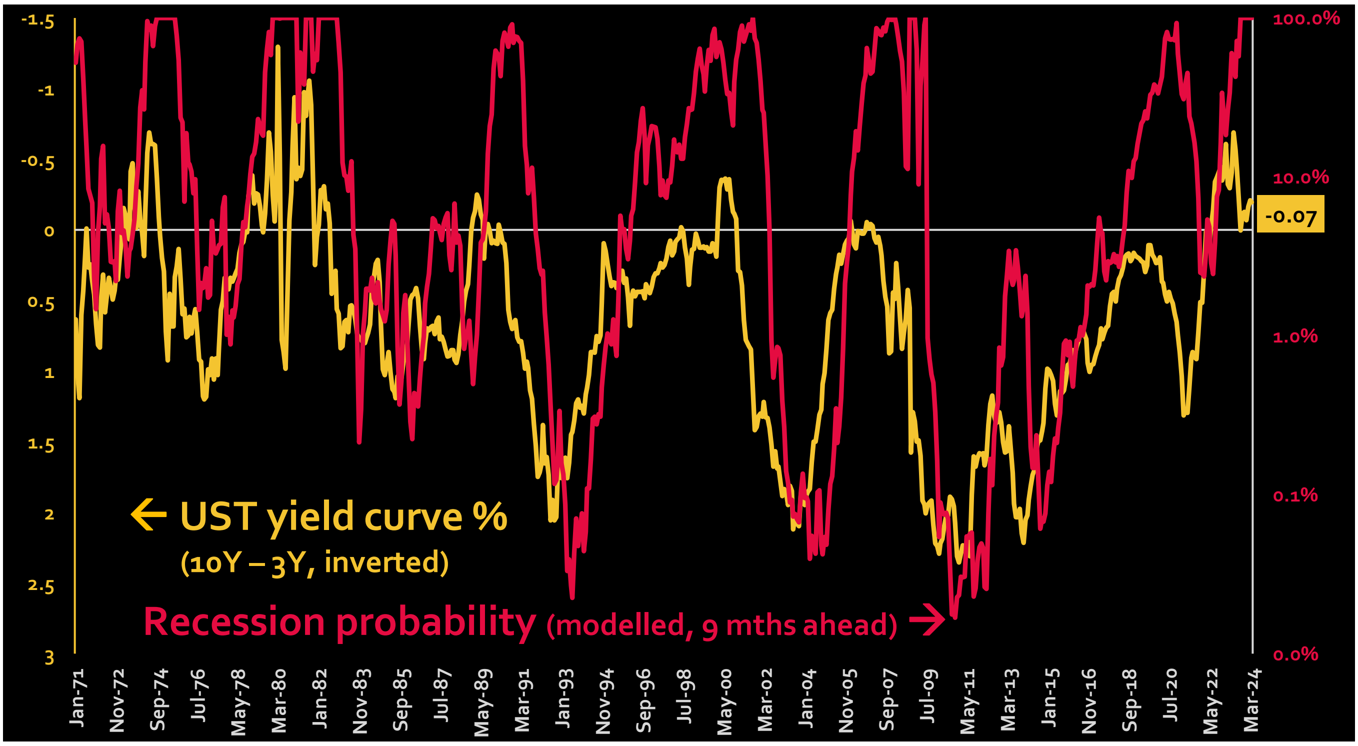
Panel 3. **The Fed remains confident in its ability to deliver a "soft landing", but the market is increasingly positioning for a "no landing" scenario.**





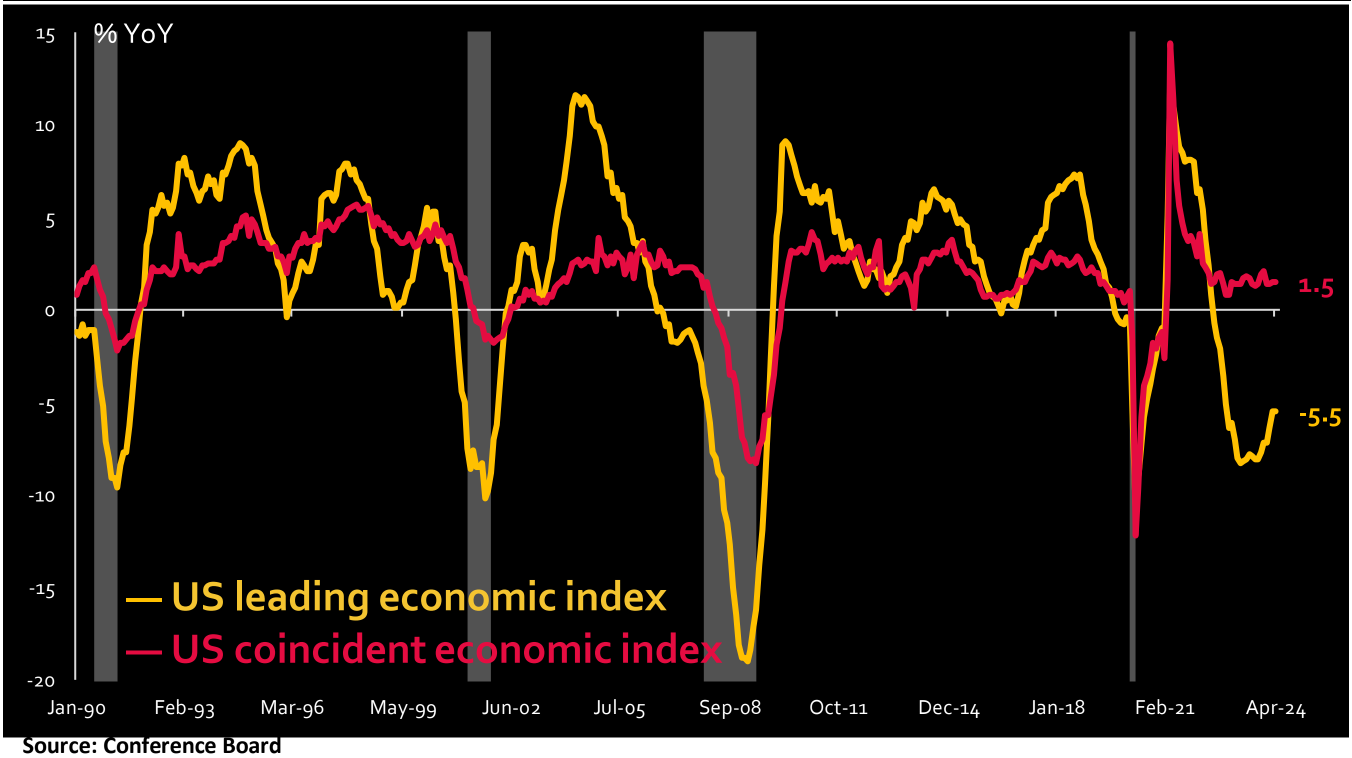
Source: Bloomberg, Federal Reserve

Panel 4. **The separation between interest rate and balance sheet policies improves the Fed's ability to navigate the financial market amidst an inverted yield curve environment**



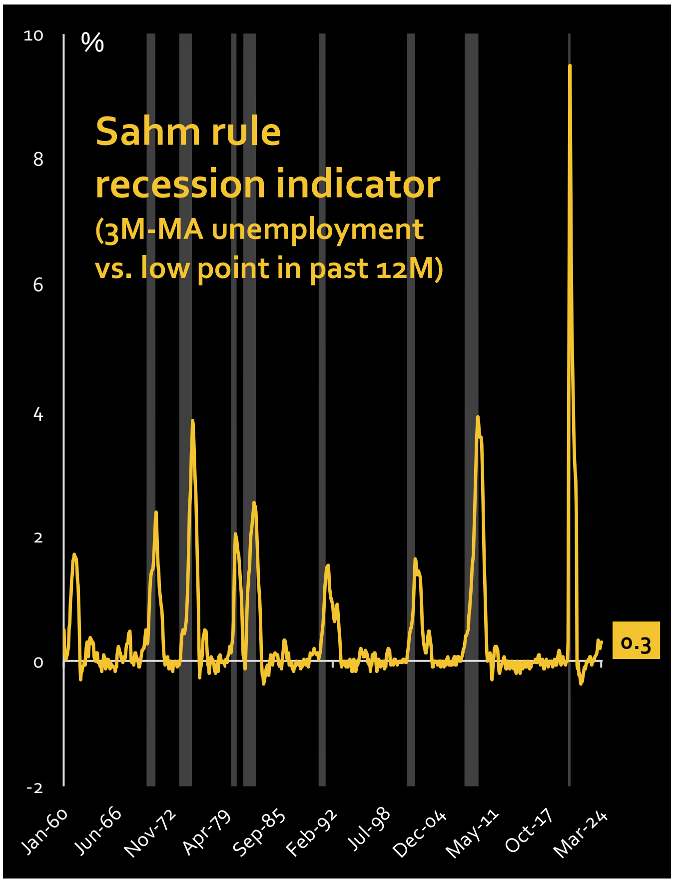
Source: Bloomberg, calculations by BCA Economist

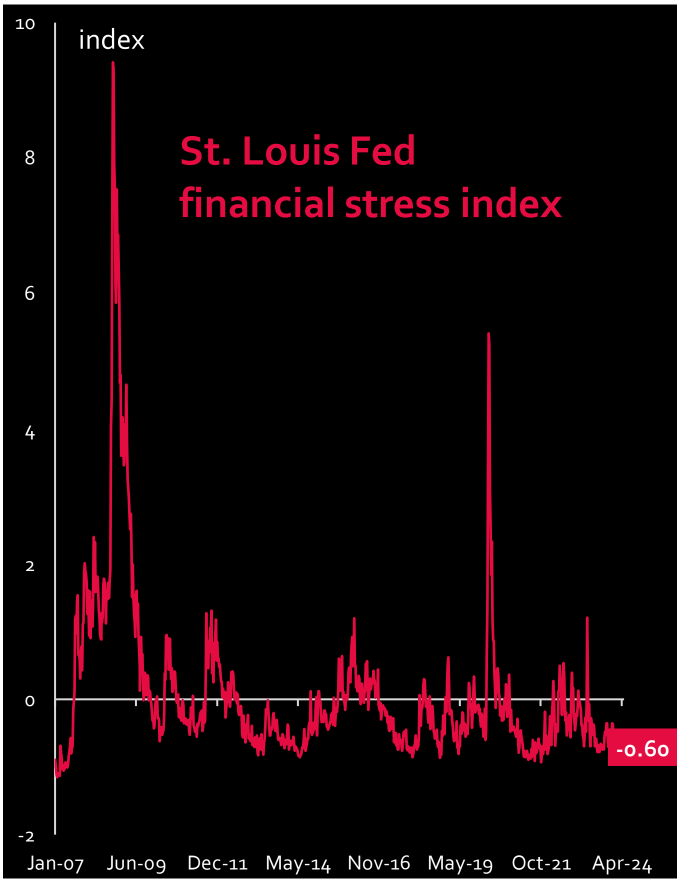
Panel 5. **The upswing in the US leading economic index highlights the growing gap between the US and global economic growth momentum that may strengthen the USD.**



Source: Conference Board

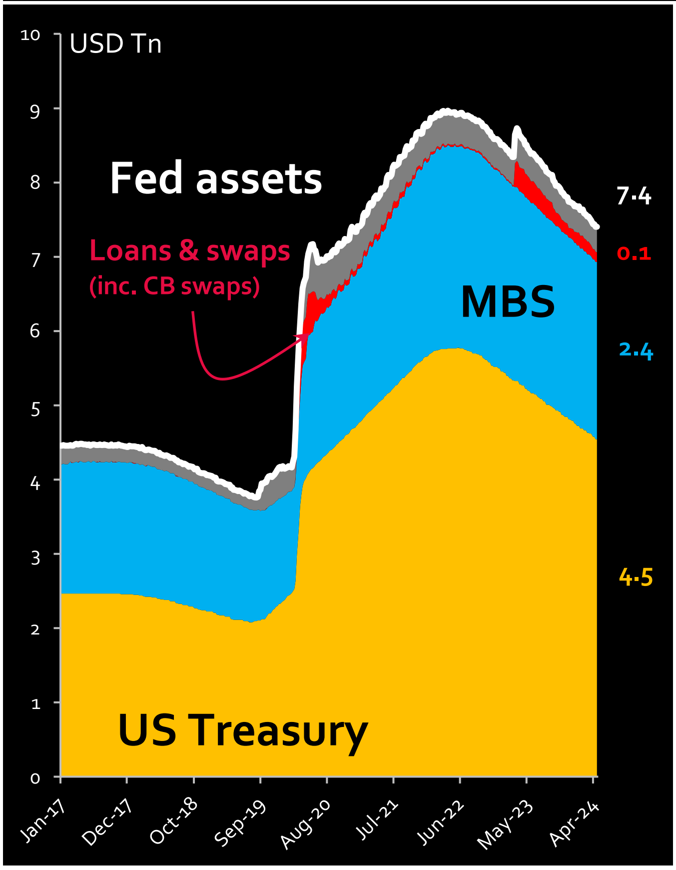
Panel 6. **Both on the real and financial sides, signs of impending US recession remain limited**

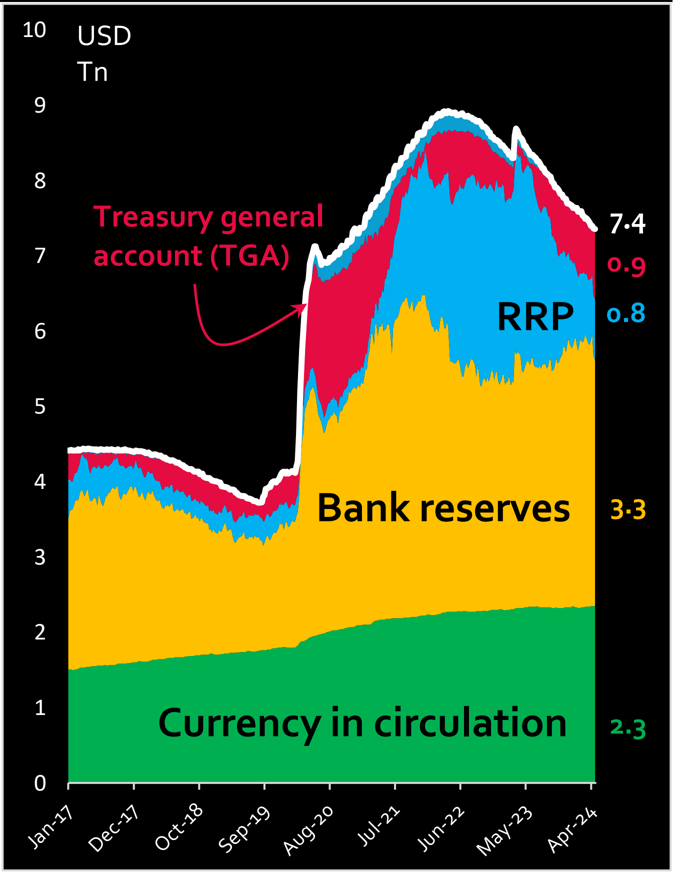




Source: St. Louis Fed

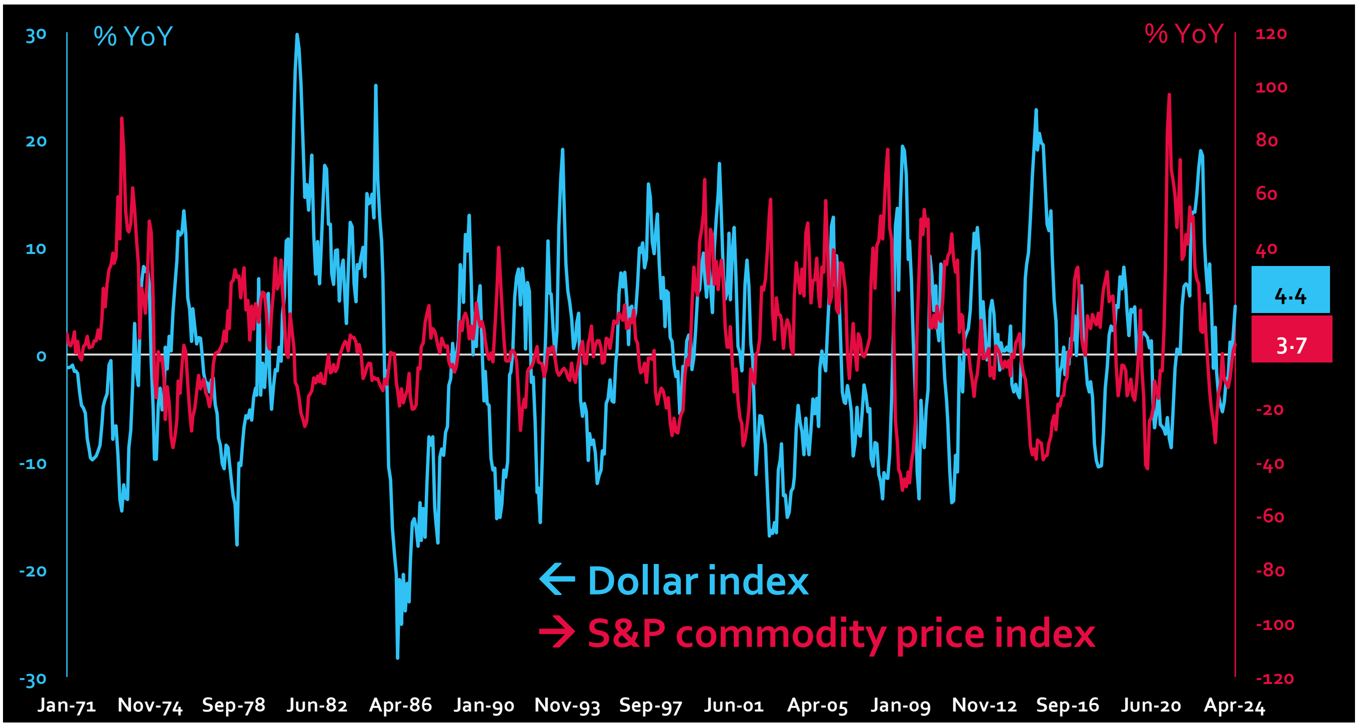
Panel 7. **The improving liquidity condition within the US banking system did not stop the Fed from tapering its UST run-off campaign.**





Source: St. Louis Fed

Chart 1. **The USD may move from strength to strength, given the widening monetary policy gap between the Fed and other central banks**



Source: Bloomberg

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	5.50	Jul-23	2.00
UK	5.25	Aug-23	2.05
EU	4.50	Jul-23	2.10
Japan	-0.10	Jan-16	-2.80
China (lending)	2.50	Aug-23	4.25
Korea	3.50	Jan-23	0.60
India	6.50	Feb-23	1.65
Indonesia	6.25	Apr-24	3.25

Money Mkt Rates	30-Apr	-1 mth	Chg (bps)
SPN (1M)	5.88	5.80	7.6
SUN (10Y)	7.22	6.69	52.5
INDONIA (O/N, Rp)	6.07	5.91	16.6
JIBOR 1M (Rp)	6.90	6.65	26.0

Bank Rates (Rp)	Jan	Dec	Chg (bps)
Lending (WC)	8.87	8.86	1.70
Deposit 1M	4.68	4.76	-7.90
Savings	0.68	0.69	-1.30

Currency/USD	30-Apr	-1 mth	Chg (%)
UK Pound	0.801	0.792	-1.04
Euro	0.938	0.927	-1.15
Japanese Yen	157.8	151.4	-4.09
Chinese RMB	7.241	7.222	-0.26
Indonesia Rupiah	16,260	15,855	-2.49

Capital Mkt	30-Apr	-1 mth	Chg (%)
JCI	7,234.2	7,288.8	-0.75
DJIA	37,815.9	39,807.4	-5.00
FTSE	8,144.1	7,952.6	2.41
Nikkei 225	38,405.7	40,369.4	-4.86
Hang Seng	17,763.0	16,541.4	7.39

Foreign portfolio ownership (Rp Tn)	Apr	Mar	Chg (Rp Tn)
Stock	3,294.9	3,226.6	68.31
Govt. Bond	791.0	810.7	-19.68
Corp. Bond	8.4	9.4	-0.97

Trade & Commodities	30-Apr	-1 mth	Chg (%)
Baltic Dry Index	1,685.0	1,821.0	-7.5
S&P GSCI Index	586.2	582.5	0.6
Oil (Brent, $/brl)	87.9	87.5	0.4
Coal ($/MT)	145.1	139.6	3.9
Gas ($/MMBtu)	1.68	1.54	9.1
Gold ($/oz.)	2,286.3	2,229.9	2.5
Copper ($/MT)	9,892.4	8,766.5	12.8
Nickel ($/MT)	19,065.0	16,568.0	15.1
CPO ($/MT)	809.0	906.7	-10.8
Rubber ($/kg)	1.58	1.60	-1.3

External Sector	Mar	Feb	Chg (%)
Export ($ bn)	22.43	19.27	16.40
Import ($ bn)	17.96	18.44	-2.60
Trade bal. ($ bn)	4.47	0.83	436.66
Central bank reserves ($ bn)*	140.4	144.0	-2.53

Prompt Indicators	Mar	Feb	Jan
Consumer confidence index (CCI)	123.8	123.1	125.0
Car sales (%YoY)	-26.2	-18.8	-26.1
Motorcycle sales (%YoY)	-7.8	-2.9	-3.7

Manufacturing PMI	Apr	Mar	Chg (bps)
USA	50.0	51.9	-190
Eurozone	45.7	46.1	-40
Japan	49.6	48.2	140
China	51.4	51.1	30
Korea	49.4	49.8	-40
Indonesia	52.9	54.2	-130

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

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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$)	4175	3912	4350	4784	4920	5149
Consumer Price Index Inflation (% YoY)	2.7	1.7	1.9	5.5	2.6	3.2
BI 7 day Repo Rate (%)	5.00	3.75	3.50	5.50	6.00	6.50
USD/IDR Exchange Rate (end of year)**	13,866	14,050	14,262	15,568	15,397	16.119
Trade Balance (US$ 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

*Estimated number

** Estimation of Rupiah's fundamental exchange rate

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