The bipolarity of our exchange rate concern

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Summary

- Indonesia's increasing imports from China has led to a deepening domestic CNY liquidity problem, as more imports are now paid in CNY while exports continue to be billed in USD.
- The CNY mismatch problem may lead to more China-backed investments and debt in Indonesia, as the Chinese financial market offer limited opportunities for CNY holder to put their surplus liquidity at home.
- Increasing import payments in CNY and higher exposure to CNY-denominated loans mean that the Indonesian real sector may not benefit from a stronger CNY.

- Recent development in the US financial market seems to follow what the market and the Fed have expected since weeks ago. The core PCE index, the Fed's favourite inflation gauge, increased by a meagre 0.2% MoM (2.6% YoY, 2.7% YoY in July 2024) – strengthening the ground for the Fed's soft-landing scenario. Strong corporate revenue growth in Q2-2024 (especially for chip producers) also continues to breathe strength into the AI-driven US stock market, although some traders appear to have abandoned their position as semiconductor manufacturers' revenue growth rates may have peaked in the last quarter.
- Positive development in the US financial market also translates positively to the Indonesian financial market. Dovish expectations for the global USD liquidity condition encourage foreign investors in Indonesia to adopt a risk-on posture, as indicated by the USD 0.25 Bn inflows to the domestic stock market.
- Meanwhile, foreign investors' appetite for Indonesian government bonds seems to have subsided, as the dovish policy signal is already priced in. However, the recovering inflow (USD 0.1 Bn, USD 0.02 Bn in the previous week) to the SRBI market may also indicate that the lower demand is due to the higher upside potential elsewhere in the Indonesian financial market.
- The returning foreign inflows are a net positive for the Rupiah. The currency has held below 15,500/USD since last week, although Bank Indonesia's still-ongoing liquidity absorption campaign (especially through the SRBI market) may have caused the currency to overshoot its fundamental value. As we have argued earlier, the 3.96% QTD decline in the USD value (according to the DXY index) should allow BI to loosen the domestic financing condition, with SRBI unwinding offering the best option given its bigger magnitude and shorter policy lag.

Expensive USD no more, but the CNY shortage came

- The Rupiah, of course, is not the only benefactor of the weakening USD's value. Other ASEAN currencies, such as the MYR and the THB, appreciate more than the Rupiah in QTD terms, thanks to the still-robust CA surplus in those two industrialised economies. The consensus on a weaker USD has also led to the CNY gaining strength in recent weeks (***see Charts 1***), which may have more impact on Indonesia and other economies in upcoming periods.
- The CNY's significance to the Indonesian economy could be described by looking at the Indonesia-China trade structure. The Ricardian trade model is evident in the Indonesia-China trade pattern, where Indonesia almost exclusively exports commodities and commodified goods (such as products under HS72 and HS75 classifications), while China mainly exports manufactured goods to Indonesia. However, **this Ricardian trade pattern seems to have deepened the CNY shortage problem in Indonesia** (***see Chart 2***), as an increasing number of Chinese producers seem to have moved on from the USD and started demanding payment in CNY while China's effort to de-dollarise the commodity market does not seem to be gaining tractions.

"The lack of progress to de-dollarise the global commodity trade has led to the CNY shortage problem for Indonesia"

- A shortage for one is, of course, a surplus for another—especially in the zero-sum world of global trade and financial flows. In this case, Chinese importers are holding the CNY surplus, which, unlike the USD and its US Treasury market, lacks the infrastructure to clear the surplus by facilitating more consumption through market mechanisms. Hence, **Chinese importers may have limited options but to save their CNY surplus, allowing the CNY to appreciate. However, this outcome is unlikely to be desirable for Chinese authorities**, given the ongoing deflationary woes still affecting the Chinese economy.
- **Another way for Chinese importers to clear their CNY surpluses is through investments or lending abroad**, and this is what Indonesia is starting to benefit from. China's investments abroad are often viewed squarely through the lens of geopolitical power projection, although it is evident that the growing CNY surplus from trade also creates an economic incentive to clear that surplus by investing abroad.
- Alas, **Chinese investments may continue to deepen Indonesia's CNY deficits**. FDI inflows from China are still concentrated in the extractive sector, while Chinese investment in the manufacturing sector (outside of the base metal industry) also more often stimulates Indonesia's imports of Chinese goods rather than boosting exports to China (***see Chart 3***). Meanwhile, the higher demand for foreign workers to man these China-funded greenfield FDI projects further adds to Indonesia's CNY deficit problem, as indicated by the rapid growth of remittances from Indonesia to China recorded in the Q2-2024 BoP number.
- Another channel for CNY holders to clear their surpluses is through the external debt market. **The need to clear its CNY surplus abroad compels China-backed lenders to offer more**

attractive lending facilities, while Indonesian (and other) importers' limited CNY liquidity also fuels the demand for such loans. It is not surprising, then, that CNY-denominated loans by the Indonesian private sector have swelled by 52.74% YoY by the end of June 2024 (compared to 0.34% YoY overall growth), reflecting the higher demand and more attractive requirements for CNY-denominated external loans.

- Indonesia's deepening CNY deficits and higher exposure to CNY-denominated loans mean that the balance of risk is not exclusive to the Fed and the USD but also to the PBOC and its CNY. The CNY's recent appreciation may pose a threat to the IDR, but it is important to note that market expectations regarding the CNY's value (relative to the USD) remain divided at this time.
- On the one hand, some China watchers have warned against a strengthening CNY due to the Fed cutting the FFR. Analysts speculate that declining short-term rates (and thus lower yields) in the US may tempt Chinese investors to leave their positions in the US market and come back home, with one analyst even predicting that as much as USD 1 Tn worth of capital could return from the US to China, leading the CNY to appreciate by around 10%.
- However, we are taking this inflow-driven CNY appreciation thesis with a lower conviction. Reports suggest that Chinese regulators are already throwing caution due to its sky-rocketing bond valuations (the 2Y government bond yield is at its lowest level since July 2009), meaning that Chinese authorities are likely to spring into action given that a watershed of capital inflows may further suppress the yield in China's domestic bond market. Many in the market have expressed support for Chinese authorities to act and issue more debt to address this bubble risk. Alas, the authorities' apparent resistance to more significant demand-side fiscal intervention suggests that some form of capital control seems to be the likelier course of action.
- On the other hand, **the anaemic domestic demand highlights the incentive for the PBoC to provide more support to the economy, thus preventing the CNY from rising as the Fed loosens its policy rate**, which would also preserve China's strength in the export market. However, given the already low short-term rates in China (and the 1-year MLF also at historic lows), it is uncertain how far the PBoC could follow the Fed in lowering its policy rates.
- **The PBoC, then, seems to be facing a liquidity trap.** Further lowering the policy rate may not provide much liquidity to the market, while the little liquidity added to the market may further encourage a bond bubble. **The current real rate conditions compared to the Fed and the piling CNY surplus due to one-sided de-dollarisation may also cause the CNY to strengthen more than planned** – which is not a desirable outcome for both China and the global economy.
- While the central bank might have been pushing on a string, many in the market argued that the Chinese government still have a lot of ground to cover. Multiple analysts and China watchers have advocated for demand-side fiscal stimulus to alleviate China's problem. Indeed, the expanded aggregate demand due to higher public sector consumption may eventually spill over to the demand condition in the household sector, while debt issuance needed to finance the fiscal programme will

address the bubble issue in China's government bond market.

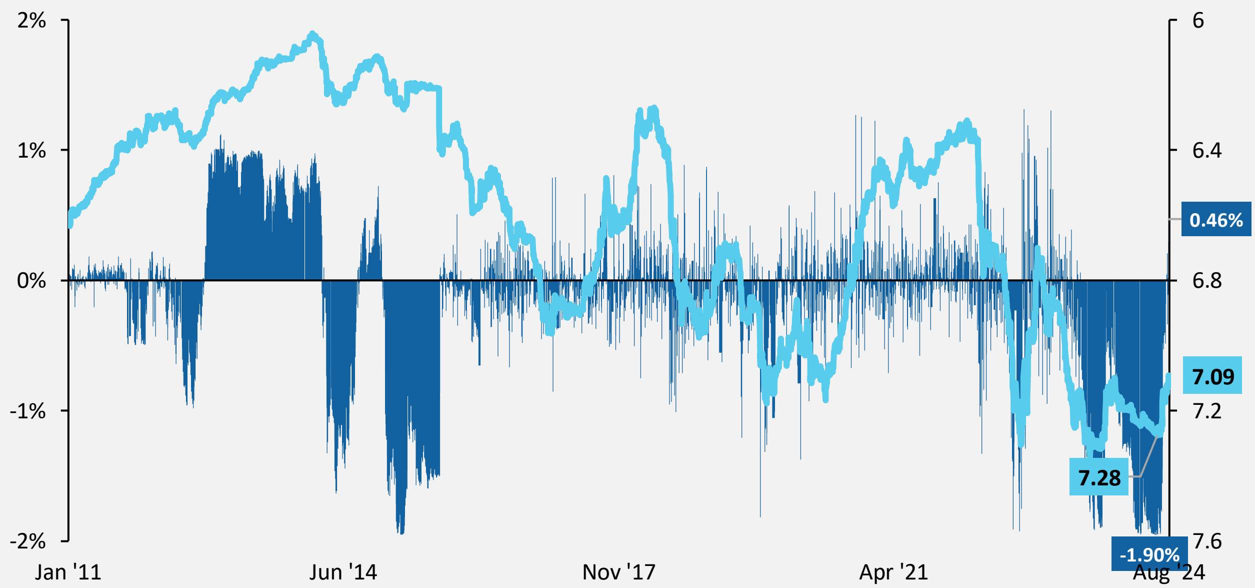
- Finally, the now-higher CNY import payments and exposure to CNY-denominated loans mean that the real sector in Indonesia (especially importers and consumers, though not the manufacturing sector) would benefit more from a stable CNY/IDR cross rate, which may result from the proposed policy actions. Alas, economic policymaking in China is rarely explainable solely through economic textbooks. After all, the whirlwind of speculation surrounding the Fed and the FFR has just passed, allowing us to sit back and see how things in China will develop in the coming months.

"Higher import payments in CNY, and increasing exposure to CNY loans, means that the Indonesian real sector may benefit more from a weaker CNY"

Chart 1

The not-so-long march

The CNY has been strengthening against the USD lately, but its further upward move may be limited given the PBoC's ongoing effort to prop up the demand condition in China.



Source: Bloomberg

Chart 2

CNY shortage

Despite the depreciating USD, the deepening CNY liquidity shortfall in Indonesia may also pose a threat to importers and the IDR.

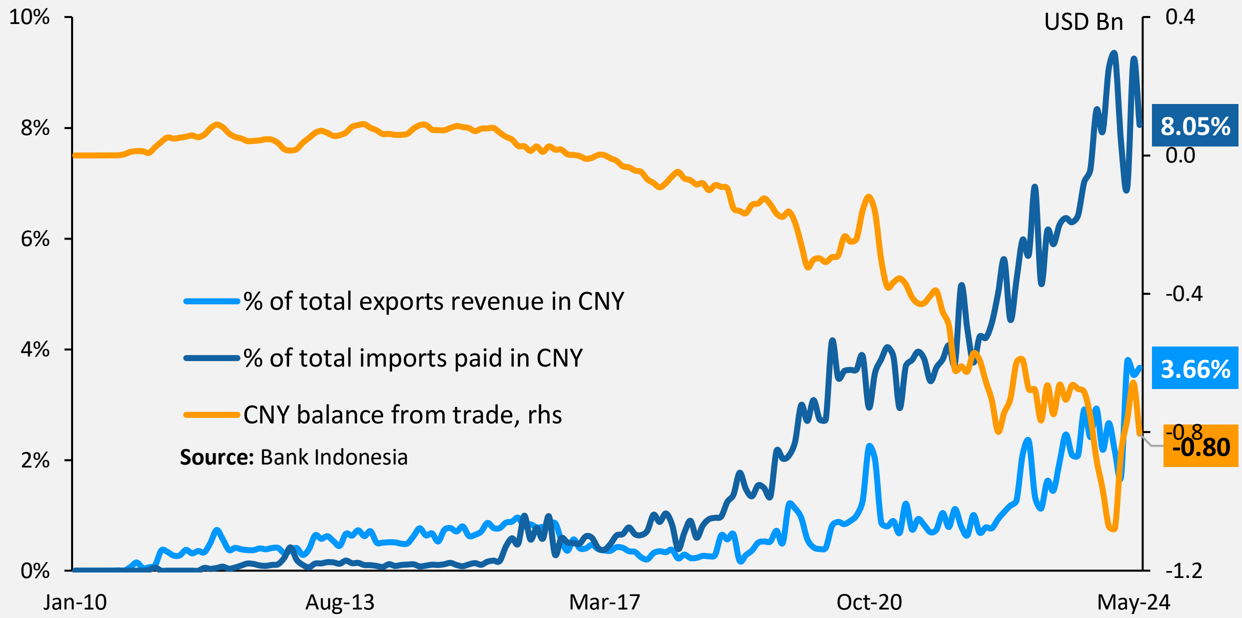
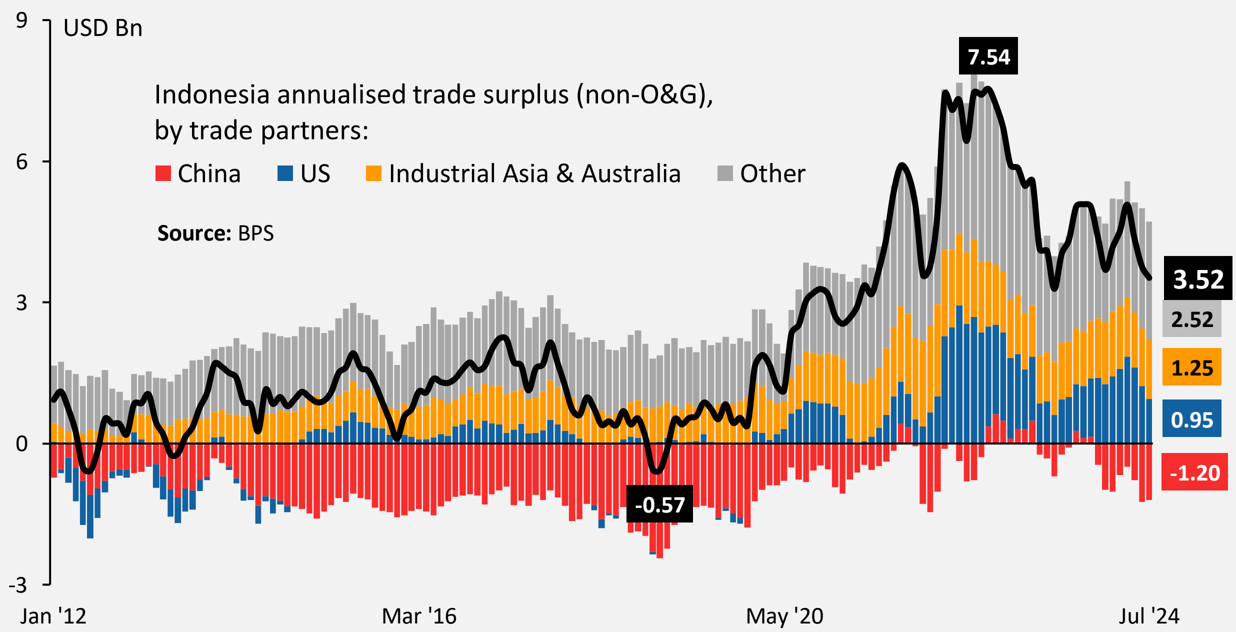


Chart 3

From investment recipients to net buyers

Indonesia lost its trade surplus against China as China-made machinery, electronics, and vehicles are gaining market share in the domestic market.



Economic Calendar

		Actual	Previous	Forecast*
02 September 2024				
ID	**CPI Inflation YoY, %**	**2.12**	**2.13**	**2.30**
ID	S&P Global Manufacturing PMI	48.9	49.3	49
03 September 2024				
US	S&P Global Manufacturing PMI		49.6	4.8
US	Redbook YoY, %		4.1	4.1
04 September 2024				
US	JOLTs Job Openings, Mn		8.184	8.9
US	Balance Of Trade, Bn		-73.1	-72.5
US	JOLTs Job Quits, Mn		3.282	3.1
05 September 2024				
EU	Retail Sales YoY, %		-0.3	0.1
US	Non Farm Payrolls, K		114	100
06 September 2024				
ID	**Foreign Exchange Reserves, Bn**		**145.4**	
07 September 2024				
CN	Balance of Trade, Bn		84.65	79.0
09 September 2024				
CN	Inflation Rate YoY, %		0.5	0.5
10 September 2024				
ID	Retail Sales YoY, %		2.7	
11 September 2024				
US	Inflation Rate YoY, %		2.9	
ID	Motorbike Sales YoY, %		26	
ID	Car Sales YoY, %		-7.9	
14 September 2024				
CN	Retail Sales YoY, %		2.7	
17 September 2024				
ID	**Balance of Trade, USD Bn**		**0.47**	
18 September 2024				
ID	**Interest Rate Decision, %**		**6.25**	
19 September 2024				
US	Fed Interest Rate Decision, %		5.5	5.0
23 September 2024				
ID	M2 Money Supply YoY, %		7.4	

*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	Jul-23	2.60
UK	5.00	Aug-23	2.80
EU	4.25	Jul-23	2.05
Japan	-0.10	Jan-16	-2.90
China (lending)	2.30	Aug-23	3.85
Korea	3.50	Jan-23	0.90
India	6.50	Feb-23	2.96
Indonesia	6.25	Jul-24	4.13
Money Mkt Rates	**30-Aug**	**-1 mth**	**Chg (bps)**
SPN (3M)	6.42	6.56	-13.6
SUN (10Y)	6.62	6.92	-30.1
INDONIA (O/N, Rp)	6.35	6.22	13.1
JIBOR 1M (Rp)	6.90	6.90	-0.1
Bank Rates (Rp)	**Jun**	**May**	**Chg (bps)**
Lending (WC)	8.82	8.86	-3.79
Deposit 1M	4.70	4.68	2.60
Savings	0.67	0.67	0.02
Currency/USD	**30-Aug**	**-1 mth**	**Chg (%)**
UK Pound	0.762	0.779	2.27
Euro	0.905	0.925	2.15
Japanese Yen	146.2	152.8	4.52
Chinese RMB	7.091	7.241	2.11
Indonesia Rupiah	15,455	16,300	5.47
Capital Mkt	**30-Aug**	**-1 mth**	**Chg (%)**
JCI	7,670.7	7,241.9	5.92
DJIA	41,563.1	40,743.3	2.01
FTSE	8,376.6	8,274.4	1.24
Nikkei 225	38,647.8	38,526.0	0.32
Hang Seng	17,989.1	17,002.9	5.80
Foreign portfolio ownership (Rp Tn)	**Jul**	**Jun**	**Chg (Rp Tn)**
Stock	3,322.0	3,273.1	48.98
Govt. Bond	813.1	808.1	4.97
Corp. Bond	7.6	8.2	-0.60

Trade & Commodities	30-Aug	-1 mth	Chg (%)
Baltic Dry Index	1,814.0	1,762.0	3.0
S&P GSCI Index	536.7	539.1	-0.4
Oil (Brent, $/brl)	78.8	78.6	0.2
Coal ($/MT)	145.3	140.3	3.6
Gas ($/MMBtu)	1.87	1.86	0.5
Gold ($/oz.)	2,503.4	2,410.8	3.8
Copper ($/MT)	9,118.1	8,842.9	3.1
Nickel ($/MT)	16,538.7	15,797.6	4.7
CPO ($/MT)	942.4	874.7	7.7
Rubber ($/kg)	1.84	1.65	11.5
External Sector	**Jul**	**Jun**	**Chg (%)**
Export ($ bn)	22.21	20.85	6.55
Import ($ bn)	21.74	18.45	17.82
Trade bal. ($ bn)	0.47	2.39	-80.29
Central bank reserves ($ bn)*	145.4	140.2	3.74
Prompt Indicators	**Jul**	**Jun**	**Apr**
Consumer confidence index (CCI)	123.4	123.3	127.7
Car sales (%YoY)	-7.9	-11.8	-17.4
Motorcycle sales (%YoY)	26.0	3.5	18.3
Manufacturing PMI	**Jul**	**Jun**	**Chg (bps)**
USA	49.6	51.6	-200
Eurozone	45.8	45.8	0
Japan	49.1	50.0	-90
China	49.8	51.8	-200
Korea	51.4	52.0	-60
Indonesia	49.3	50.7	-140

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** otherwis

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$)	4175	3912	4350	4784	4920	5149
Consumer Price Index Inflation (% YoY)	2.7	1.7	1.9	5.5	2.6	2.87
BI 7-day Repo Rate (%)	5.00	3.75	3.50	5.50	6.00	6.00
USD/IDR Exchange Rate (end of the year)**	13,866	14,050	14,262	15,568	15,397	16,172
Trade Balance (US$ 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 the Rupiah's fundamental exchange rate

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